The Taxation of Corporate Income

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UNIVERSITY OF ILLINOIS PRESS
1944

Published by the University of Illinois Press
under the auspices of the Graduate School

UNIVERSITY OF ILLINOIS PRESS
1918

PRINTED IN U.S.A.

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CHAPTER I

ACCOUNTING AND TAXATION

THE FEDERAL INCOME TAX LAW in this country has provoked wide discussion. The methods of administration, the rate structure, the inequities of the system, and the methods of computing taxable income all have evoked widely divergent criticisms that agree in one respect, that much dissatisfaction exists. This present study will concern itself with but one aspect of the matter: the computation of income of corporations.

The chief criticisms center about the lack of clearly expressed and permanent principles of taxation and determination of income. According to many writers, the income tax system is made to vary according to political winds, the Government's need for revenue, changes in general economic conditions, and outcries for social reform.

The income tax is not a new form of taxation; it was used in Italy in the Middle Ages. Austria had such a tax in 1702; England, in 1799; Prussia, in 1811. Many other countries followed suit in the last half of the nineteenth century.

In 1634, the Massachusetts Colony used a tax which might be considered a form of income tax. Shortly thereafter several other colonies followed the lead of Massachusetts. Although Pennsylvania, Virginia, and Tennessee tried an income tax in the latter part of the nineteenth century, it remained for Wisconsin, in 1910, to make the first really serious attempt to tax corporations under a state statute. By 1936, thirty-one states had such laws.

Some state laws are patterned very closely after the Federal income tax law, except that certain things that are locally considered unconstitutional objects of income taxation are excluded. The tendency on the part of state legislators to copy the Federal act makes it doubly important that our national statute be sound.

Prior to the passage of the 1861 act, the Federal government had not used an income tax, although one was suggested in 1815. During the Civil War, both the United States and the Confederacy taxed incomes. Additional acts were in effect in the period from 1862 through 1871. There was none in effect from 1872 to 1894, however. Although the 1894 act was declared unconstitutional, another income tax law was passed in 1909 under the guise of an excise tax.

The uncertain constitutional status of the 1909 act gave immediate impetus to a movement for constitutional amendment to allow the imposition of taxes on income without regard to apportionment according to

the census. The Sixteenth Amendment resulted and the act of 1913 was passed, retroactive to March 1, 1913.

Additional important income tax acts have been passed in 1916, 1917, 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936, 1938, and 1939. It is with the acts passed since the Sixteenth Amendment that this study is concerned.

The constitutionality of Federal income tax acts has been questioned several times. The Constitution of the United States provided that no direct tax be laid unless in proportion to the census. The usual contention has been that the income tax is a direct tax not laid in proportion to the census.

The Civil War acts were held to be indirect taxes and, therefore, constitutional. The Supreme Court, in a five to four decision, ruled that the 1894 act was a direct tax and unconstitutional. The 1909 act was disguised as an excise tax, in order to avoid the ruling made on the 1894 law.

The Sixteenth Amendment, passed in 1913, stated:

> The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

This amendment was questioned as to constitutionality, on other grounds, but was declared constitutional by the Court in *Brushaber* v. *Union Pacific Railroad* (240 U.S. 1, 1916).

The matter of constitutionality has received, perhaps, more attention than it deserves. It is said frequently that taxation of income only is permitted under the Sixteenth Amendment and that Congress may tax as income only that which the legislators and the public conceived to be income when the amendment was ratified.

The validity of the foregoing line of reasoning is very doubtful. It is not at all certain that the Sixteenth Amendment was necessary, and it is almost impossible to determine just what Congress and the people meant by "income" when they sanctioned the Sixteenth Amendment.

Some have felt that there are well-defined trends discernible in the Federal income tax. They believe that from about 1920 until about 1932 the Federal income tax showed an increasing tendency to follow existing well-recognized and well-established accounting methods, but that a less desirable tendency appeared with the 1932, 1934, and 1936 acts. They place the blame on the "New Deal" administration and the industrial and economic depression. According to this trend theory, the 1938 and 1939 acts however, show a reversal and tax regulations seem again to be moving toward the use of generally accepted accounting and economic standards of income measurement.

The existence of such views suggests the desirability of examining the Federal income tax laws and the opinions expressed by those who have

written in this field, in order (1) to determine what the proper standards and fixed principles of income tax computation should be and, (2) to ascertain whether or not there has been any noticeable trend toward or away from such standards and principles of income calculation and taxation.

Just what these standards of income determination are or should be will have to be developed. Many accountants have expressed the idea that generally accepted, uniform methods of computing accounting net income should be used as the basis for Federal income tax calculations as well as for published annual reports.

Those who advocate "generally accepted accounting principles" for use in determining taxable net income are approaching debatable ground. Enough has been written recently to cast some doubt on the assumption that there are enough well-accepted accounting principles for the determination of income to constitute a dependable basis.[1]

There is no cause for despair, however. It is possible to build up a logical accounting methodology for determining income and to use the standards thus determined as criteria with which to compare existing methods found in the practice and literature of accounting and the income tax. In building up such a set of standards we must ever keep in mind that they should be in harmony with the function which accounting has, and that in any given situation, it is necessary to judge what is or is not an allowable deviation from such standards.[2]

There also has been some criticism to the effect that the income tax acts have been too detailed in their provisions, and that such detail impedes the formulation of satisfactory general principles or standards for the tax.[3] The United States Supreme Court made a statement in *Weiss v. Stearn* (265 U.SS. 254) that:

> When applying the provisions of the Sixteenth Amendment and income laws enacted thereunder, we must regard matters of substance, and not mere form.

This is an admirable rule, but unfortunately it has not been followed always. A more detailed examination of this matter will be made in later chapters.

To carry out the purpose set forth above it is necessary to present a formulation and discussion of a theoretical basis for the determination of income and to make an historical comparison of that basis with accounting practice and literature and with Federal income tax methods of computing taxable net income. Such a three-way historical comparison calls for a discussion, theoretical in nature, regarding the differences and divergences found.

Accounting standards and practices discussed are those treated by

[1] For notes, see page 225.

various writers and associations in periodical articles, statements of standards or principles, and published books.

The Federal income tax method of computing taxable net income is that which has been put into effect in fact. In other words, a mere perusal of the Federal income tax acts themselves is not sufficient. In addition, an investigation must be made of Treasury Department regulations, Board of Tax Appeals decisions, Treasury decisions, and court rulings.

In so far as it is possible, a comparison is made between accounting practices and tax methods, and accounting and tax rulings, of about the same time.

The income tax law to be studied is that which was passed following the Sixteenth Amendment and which has been in effect from March 1, 1913; the laws of earlier years are mentioned only in passing and are discussed briefly to furnish an historical background for the modern Federal income tax law.

Only the Federal income tax law is discussed; state and foreign laws are ignored. Conflicts between state and foreign laws and the Federal income tax laws are outside of the scope of this study.[4]

The income tax law and accounting standards discussed are those which concern ordinary, operating, domestic business corporations only. Single proprietorships, individuals, and partnerships are excluded because each of these presents some differences from corporations, and each is a large problem in itself. The weight of taxation falls differently on each, and is a matter of great importance.[5]

Only domestic corporations are to be considered; foreign organizations are faced with special rules which are not applicable to corporations in general and which are not important to the main theme of this study.

The restriction of this study to *ordinary business corporations* eliminates any treatment of special types of businesses, such as banks, insurance companies, railroads, and financial or monied companies. Omitted also are those acting in fiduciary or trust capacities, China Trade Act corporations, tax-free companies, mutual investment companies, personal holding corporations, and personal service corporations.

Only *operating* corporations are to be studied; this for the reason that the main postulate underlying a rational system of standards for an operating company is that a *going concern* concept and not a *liquidation* concept must be visualized and used. Since these two concepts are very different and each is complex in itself, it is better that the more unusual class of businesses, that is, corporations undergoing liquidation or reorganization, be omitted here.

Since our principal purpose is to study the income tax methods of determining net income, it follows that administration and general tax

problems are not within the present sphere of interest. There will be no discussion of the following items except for fragmentary bits which are incidental to a discussion of other things: rates, exemptions, surtaxes, war profits taxes, excess profits taxes, undivided profits taxes, capital stock taxes, taxation at source, tax-free covenant bonds, information at source, collection methods, penalties, tax avoidance and evasion, social justice, inequities, double taxation, reciprocity, or foreign exchange problems.

The various surtaxes, excess profits taxes, undistributed profits taxes, etc. are excluded because they are not primarily income taxes; being really special forms of taxation and regulation superimposed on an income tax system and designed to bring about the promotion of social good or the suppression of social ills.

Accounting for consolidated accounts and related enterprises is an extremely large subject in itself, and for that reason there is included here only a very limited discussion of the theoretical aspects of allowance or disallowance of consolidated figures when net income is being calculated.

In addition to all of the other restrictions on the scope of this examination, certain other limitations must be mentioned. These take the form of unavoidable weaknesses in the research itself.

Articles and books written on the subject of accounting have a tendency not to be representative of practice at the time they are written. The theory of the most of these works is superior to existing practice. To the extent that this is true, we shall subject the income tax provisions to an unfair comparison, because much has been written on ideal standards, while the record of actual accounting practice is sparse. There is no practicable way to find out what was being done in everyday accounting activities; all we can do is use as evidence the ideas published in books or reported as spoken at conventions and other meetings.

In an examination of the historical development of the attitude of the courts or other regulatory agencies, certain difficulties are encountered. For example, an interpretation of the Supreme Court in 1924 cannot be considered completely representative of its attitude on the income tax law of 1924, because the Court may be deciding a case that is based on an act of a prior year. Nor can we say that a decision handed down in 1924 based on the 1921 act, for instance, is altogether indicative of a 1921 interpretation of the 1921 act, because new philosophies and new members of the Court create new lines of reasoning which, perhaps, would not have been used in the year of 1921. Such inaccuracies, however, probably do not substantially affect an analysis of trends.

In many places in this study it is indicated that there have been no changes in the law. This statement means merely that there have been no

changes of importance to this study; mere changes in wording, provisions for administration, etc., are not considered important changes for present purposes.

When a provision which has appeared in the law for several years is omitted in the act of a particular year, it can not be assumed that there has been a basic change in the law. Sometimes such deletions are made merely because the provision affected is considered redundant and adequately covered by other sections. Very frequently there is no determinable evidence of the reasons for such changes.

In general, decisions of courts and governmental agencies have been gathered from reputable standard tax services rather than from original sources, because such secondary references are considered reliable, and the use of original sources would have involved a prohibitive amount of research work.

In order to judge how well an income tax is functioning, it is necessary to know whether or not it conforms in general to the principles of taxation. A good tax system should place the weight of taxation according to ability to pay, should be simple and economical in administration, should be certain and convenient in operation, should be easy of expansion and contraction, should be adjustable to new conditions, should preserve the source of revenue, should be coordinated properly in all of its parts, and should have desirable economic, political, and social effects.

A net income tax conforms to the first requirement of ability to pay, perhaps, in a greater degree than do most other forms of taxation. In practice the Federal income tax has been criticized severely on the ground that it has not all of the other desired characteristics enumerated above. The principal fault appears to be that the income tax base has not been planned carefully and is undergoing constant change. The remedy appears to be the formation of a well-planned tax base; changes necessitated for expansion and contraction in government revenues can then be made by altering rates instead of changing the base.

Preservation of the source of revenue can be provided for in good fashion if the tax is on net income and if careful distinction is maintained between capital and income.

The requirement that a tax have desirable economic, political, and social effects is one which has raised much controversy and is a major cause of many of the differences which exist between income tax and accounting methods of computing income. Just how far this requirement should be honored is a question. Should the tax, merely in its revenue-gathering capacity, have desirable effects or lack of undesirable effects, or should more be required? Should measures be incorporated, foreign to revenue-gathering purposes, which are designed to attain actively some social end? Social considerations have found a place in income

taxation in the guise of graduated and progressive rates, differentiation between sources of income, exemptions from tax, and similar items.

Many of the difficulties with the income tax can be traced to provisions designed to correct social ills or to plug loop-holes in the law. Social aims might be taken care of better by a system of subsidies or penalties entirely separated from the revenue-gathering system. If less stress were placed on the mere form of transactions and more on their substance in the enforcement of the income tax acts and in the decisions of the courts, a more simplified tax system might result, and less attention would be needed to plugging loopholes.

Perhaps evasion cases could be handled as individual problems by the courts in each case. A case method of approach similar to that used by the Securities and Exchange Commission in its administration of the Securities Act and the Securities Exchange Act could be adopted.

If detailed provisions were excluded from the law, the more clever manipulators of tax calculations would not have a line within which they could twist and torture their operations in order to take advantage of tax saving technicalities. Under present conditions, manipulators figure out a way to avoid the law; next the Bureau of Internal Revenue puts into operation or Congress inserts into the law a provision which turns such avoidances into actionable evasions. A case method would make avoiders watch their step, since their actions would be judged intelligently and not merely compared with a faulty enumeration of illegal practices.

The objection might be raised that such a plan would inject too much uncertainty into the tax system, but, at least, much of the complexity of the present system would be removed. A choice between two evils must be made. The evil of uncertainty might be eliminated if proposed transactions were submitted for the scrutiny and opinion of the Bureau of Internal Revenue or of some court of accounting opinion preliminary to their actual use by a taxpayer.

In spite of its shortcomings, the tax on net income appears to be the most satisfactory method of taxation.

CHAPTER II

WHAT INCOME IS

THE NATURE OF INCOME has been the subject of much discussion and disagreement. Differences are found between and even within the legal, economic, and accounting concepts of income. It is difficult to determine just what income is. Perhaps it is best to set forth the varying opinions of writers in each of the fields of accounting, economics, and law, and then to examine and compare their concepts. From these conflicting ideas, some general concept may be drawn which can be used as the foundation for a rational and practicably usable method for computing income for income tax and accounting purposes.

In this chapter will be examined what writers, statutes, and courts say income is. On these résumés will be founded a composite picture of what is advanced in this study as a suitable accounting and tax basis for income calculation. An examination of the detailed provisions for income computation used in accounting and tax practice is reserved to later chapters.

Economic Concept of Income

ECONOMIC concepts range from the extremely intangible psychological to the very practical. At the very foundation, "Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences."[1]

A slight variation of the above view has been expressed by Irving Fisher[2] in his characterization of income as "a flow of services through a period of time." According to this idea, income is neither commodities nor psychological benefits, but is services. Items received and saved are not income since the services are deferred.

These broad concepts are, of course, quite impractical. Views more suitable to measurement for business purposes have been expressed by Haig and others.[3]

> . . . the definition of income which the economist offers is this: Income is the money value of the net accretion to one's economic power between two points of time.[4]

This definition is stated in terms of the power to satisfy wants rather than in terms of the services received or in the satisfaction themselves.[5] Power is measured in a practical way, money value. This does not mean, of course, that a money or cash basis is used. In fact, this concept does not even require objective realization; and to the extent that objective realization is not required, it may be questioned whether this is a practicable

method for either accounting or tax purposes. It approaches very closely to a balance sheet method of income calculation found in single entry accounting.

Haig's concept is a net income idea and involves periodicity of income measurement. Since objective realization is not a part of this definition, appreciation due to market price increases is considered income, so long as the increase actually gives increased economic power and does not merely represent a general rise in the price level.

Concepts similar to that of Haig have been expressed by Taussig,[6] Plehn,[7] Pulgrave,[8] Fetter,[9] and Marshall.[10]

The broadest idea of income is that it is the total of psychological satisfactions received. Some economists ignore satisfactions and include only a flow of services and commodities received. The service concept is similar to the satisfaction concept and excludes savings from income. These very basic ideas are impracticable because of the difficulties which are involved in measurement of subjective items.

A much more useful definition of income is the money value of accretions to economic power. Money value is the common denominator for measurement. Satisfactions and other immeasurables are excluded from the scope of economic power in this modified conception. This economic concept of income is quite similar to the broadest accounting concept. It is a net income concept. Unless wealth or benefits are received over and above the exhaustion of the capital which has been used for their production, there can be no accretion to economic power.

This definition is not free from all objection, however. Economic power implies value and purchasing power, both of which often take the form of unrealized incomes, and usually such items are very difficult of measurement.[11]

Some economic definitions of income include the idea of steady flow, of continuity; continuity implies a restriction of income to operating results achieved in artificially limited periods.

The general economic concept contains the idea that the accretion to economic power is made between two points of time. It is inherent in any measurement of increase or decrease that a time interval be considered. This does not imply that periodicity in computing income is important to the economist, however. Periodicity is more the problem of accounting and income taxation. By periodicity is meant the reflection of arbitrary short-term time intervals in income calculation.

Whether or not income should include non-operating gains is a subject of much dispute. Probably from the point of view of society as a whole, such gains are not income, since there is no change in the total sum of capital in existence. From the point of view of an individual economic entity, however, such items do constitute income. The broad economic

definition of private income does not even require that such gains be realized objectively.

Gains due solely to changes in the general price level are not income, because there is no accretion to economic power. The entity which has made this *gain* is merely holding its position in the face of a general increase of prices. It may be said, likewise, that a part of operating results also are, in fact, not gains or losses but merely a reflection of changes in the general price level.

Accounting Concept of Income

There are two principal accounting conceptions of income; one is an operating income concept; the other is an all-inclusive concept.

In this study, the terms *income* and *profits* are used interchangeably. Some writers have advocated the separation of the use of these two words. This separation is desirable, perhaps, but there appears to be no widespread agreement as to what each should represent.[12]

The broadest accounting definitions of income approach the economic concept.

> . . . the increase in proprietorship which has taken place during that period, making due allowance for any part of such increment as may have been distributed. This is the broadest use of the terms, but is one which is occasionally employed by both accountants and economists.[13]

Similar expressions have been made by H. A. Finney,[14] W. A. Paton,[15] Robert H. Montgomery,[16] and W. A. Hosmer.[17]

For various reasons, chiefly practical, limitations have been placed around such broad concepts of income. Here are some examples.

> The term *net income* should be used only to designate the amount arrived at by stating the income actually accrued during a stated period, collected or collectible, less the cost thereof actually paid, and less further costs accrued but not paid, such as depreciation, obsolescence, taxes, and other charges apportioned against the income such as reserves for strikes, workmen's pensions, etc.[18]

> For example, one might urge that no tax be placed on a gain arising from the appreciation of a fixed asset until it is actually sold. But the recommendation should not be urged on the ground that the appreciation is not income until it is sold. The economic fact is that the owner of that asset comes into possession of economic income whenever the increase in the value of that asset is sufficient in amount and definite enough in character to be susceptible of precise evaluation in terms of money.[19]

> In the widest possible view, profits may be stated as the realized increment in the value of the whole amount invested in an undertaking; and, conversely, loss is the realized decrement.[20]

> . . . the term profit has been applied to those increments of value arising from whatever source, which flow from completed transactions with outsiders, as distinguished from the corporation's dealings with itself or its stockholders.[21]

In addition to the limitation of income to so-called realized items, many writers attempt to restrict income to ordinary and recurring operating items alone.

Newlove, Smith, and White define income as

. . . the gain or remuneration which proceeds from property, labor, or business,[22]

but they also mention that

income may be classified as primary or operating revenue and secondary or non-operating revenue.[23]

Robert H. Montgomery says:

If a public accountant were asked to define the term *net income*, he would probably reply: "The net income of a business is the surplus remaining from the earnings after providing for all costs, expenses, and allowances for accrued or probable losses."[24]

These exclusions from income are made merely because the items are exceptional in nature or extraordinary in amount. A concept based on such expediency is subject to objection on theoretical grounds; but, under certain circumstances, may be satisfactory from a practical point of view. Hatfield has expressed the matter very well in these words:

But profits is often used in a more restricted sense. It regards not all the changes which have taken place during the period but only some of them. Sometimes the concept is limited to those changes which have come about through the operations of the business, excluding extraneous gains to proprietorship; sometimes the items excluded are those which do not seem to have a recurring character and a change which is exceptional in amount may perhaps be excluded even though it arises in connection with the conduct of the business; sometimes the basis of such discrimination rests upon arbitrary legal provisions, and gains in proprietorship which may not be made the basis of dividends by a corporation are excluded from the showing of the profits of the year.[25] [and] Although excluded from the current income account, it may still be recognized as income, rather than an addition to capital, but income to be attributed to some other period, or income of a nature to be differentiated from that which is ordinarily shown in the income account.[26]

The American Institute of Accountants special committee on terminology has expressed its opinion in favor of an over-all concept of income.[27]

The basic accounting idea of income as the ultimate total profits of an enterprise from the time of its organization until it is completely liquidated is about the same as the broad economic idea of accretion to economic power. Both of these definitions exclude withdrawals and investments in computing income, of course. Both are net concepts.

This broad conception is not suitable, however, for use in the practical business affairs with which accountants concern themselves, unless some common denominator, such as money, is used as the standard of measure-

ment. The problem of measurement is further complicated by (1) the need for objectivity, i.e., some impartially chosen point at which income may be said to arise or to be realized; and (2) by the requirement of periodic computation to keep all of those interested in a business entity abreast of its progress.

In general, it may be said that the accounting concept of income excludes unrealized increments in value. Many accountants feel that accounting has not been developed yet to a point (there is some doubt, even, that accounting is capable of such development) at which values can be measured except by means of objective transactions between the business entity and outsiders. Receipt of cash, however, is not necessary for realization of income.

The requirement of computation of income for arbitrary periods of time has caused most of the difficulties and problems of accounting. Periodicity places greater emphasis on operating results than on complete results; perhaps, from a long-range point of view, these is no such thing as an extraordinary gain or loss.

There appears to be a definite trend in accounting thought toward the definition of income in terms of total rather than mere so-called operating income. This trend does not make unnecessary the segregation and classification of the various types of income items; it only requires that everything be considered in arriving at the final income figure. It has been proposed frequently that an additional section be added to the profit and loss statement to take care of items foreign to operating income of a particular accounting period.

In order to face practical difficulties and to gather information in the most convenient and economical manner, theoretically correct ideas regarding income calculation are often deliberately side-tracked for more expedient methods. Expediency is not to be condemned so long as it is used after due deliberation and does not give a result materially different from the logical method, nor develop into mere traditionalism.

Income Tax Concept[28]

THE SIXTEENTH AMENDMENT to the Constitution, Article XVI, states:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.[29]

The interpretation to be placed on the word income has occasioned much difficulty. In general, it has been felt that this word must be interpreted as it was in the minds of the public and of the members of Congress when the Sixteenth Amendment was sanctioned.[30] It is obvious that confusion must result from a concept so difficult to determine; writers and

court decisions have differed radically in their interpretations of the meaning of income.

It is extremely important to determine what is meant in a statute which uses the word *income,* because courts are chiefly interested in interpreting the intentions of the legislature as expressed in the law. They feel obligated to determine what the law says income is rather than what it is in fact.[31]

It will be noticed that the Sixteenth Amendment gave Congress power to lay taxes on incomes "from whatever source derived." This appears to mean that non-operating incomes are also to be taxed.

This view is substantiated by decisions of the Supreme Court in two cases prior to the passage of the Amendment.

In *Stratton's Independence v. Howbert,*[32] decided under the 1909 act, it was held: "income may be defined as the gain derived from capital, from labor, or from both combined."

An even more emphatic statement is found in *Doyle v. Mitchell Bros.*[33] "provided it be understood to include profit gained through a sale or conversion of capital assets."

Apparently the word *derived* in the first case and the limitation of sale or conversion in the second ruled out appreciations unrealized and included only gains realized through transfer.

At about the same time as these two decisions, the Attorney General specified a cash basis for computing income under the 1909 act. The 1913 and 1916 laws defined income as "gains, profits, and income . . . from any source whatever."

There is some confusion as to whether or not the legal idea of income is a net or gross concept. Perhaps it may be said fairly that it is a limited net concept, i.e., something neither net nor gross but a modified gross income, less certain allowable deductions only.

The Circuit Court of Appeals in *Ludington v. McCaughn*[34] expressed the opinion that:

> Taxable net again is a constitutional concept denoting income which the taxpayer has derived, while deductible loss is a creation of Congress, varying from time to time, as Congress deals with it in various ways.

The language used in this decision is not altogether clear, and the court appears to be using taxable net gain and gross income as synonymous. What is meant by deductible loss is not clear either. Does it include expenses? Apparently the idea expressed is that all income may be taxed but that no deductions need be allowed unless Congress so desires. Can this be the common idea of income under the Sixteenth Amendment? It is difficult to believe that it is.

There are many evidences that the common idea of income is net

income, i.e., those returns which are in excess of advances made.[35] The terms net profits, profits, net income, earnings, and surplus profits all carry a *net* connotation.[36] They are something which has grown out of capital, leaving the latter unimpaired and intact.[37]

The outstanding Supreme Court decision, perhaps, which has attempted to lay down a concept of income under the Sixteenth Amendment is in the case of *Eisner v. Macomber*,[38] decided on March 8, 1920.

In this case, there was quoted with approval the Supreme Court decisions in *Stratton's Independence v. Howbert* (231 U.S. 399, 415), and *Doyle v. Mitchell Bros. Co.* (247 U.S. 179, 185) decided under the act of 1909:

> Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle case.

Again, the emphasis is on gain derived from capital, i.e., realized through transfer, rather than on mere increment in the value of capital. This point is emphasized by these additional words of the decision:

> Brief as it is, it indicates the characteristics and distinguishing attribute of income. . . . The Government . . . placed chief emphasis upon the word *gain*, which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *Derived-from-capital, the gain-derived-from capital*, etc. Here we have the essential matter; *not* a gain accruing to capital; not a growth or increment of value *in* the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from capital, however invested or employed, and coming in, being *derived*—that is, received or drawn by the recipient . . . for his separate use, benefit, and disposal. . . .

This definition of income does not cover the matter of deductions to be allowed.[39]

Although it is not absolutely certain that the Sixteenth Amendment has ultimate control over the Federal income tax, it has been generally accepted that it does.[40] The courts have held that the concept of income under the Sixteenth Amendment, and therefore for income tax purposes, is that which was held by Congress and the people when the Amendment was proposed and ratified. In other words, the income tax concept of income is not distinct in itself but is a borrowed conception.

What the general concept of income was when the Amendment was passed is difficult to determine. Perhaps the best view is that the expert opinion of accountants or others actively engaged in income determination should be considered as representative of prevailing enlightened public opinion when the Amendment was passed. The corporation income tax is intended to levy on the results of business and should be placed on a basis determined by the generally accepted methods in use for the determination of income, so long as those methods are not incorrect.

The income tax law itself contains provisions which grant recognition to the idea that income should be determined according to accounting and business methods.

Section 212(b) of the 1924 and 1926 acts specifies that taxable net income shall be calculated in conformity with the method of accounting regularly used by the taxpayer, so long as such method "clearly reflects the income." Article 23 of Regulations 65 of the 1924 act provides that "approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." The Board of Tax Appeals is disposed to give consideration to correct and approved accounting standards, but it has not gone far enough in giving them adequate consideration.[41] This situation may be caused by a feeling on the part of the Board that it is dealing solely with a statutory concept of income.

Although there have been many modifications of it, the basic income tax concept of income is not greatly different from the broad accounting idea.

> The theory of the best reasoned cases on the subject of "What is income?" is that every receipt is income which is not a contribution of capital or an even exchange for a capital asset.[42]

The income tax makes use of the same measuring stick as does accounting, i.e., the monetary unit.

Basically, perhaps, the income tax concept is one of gross income. However, it has been worked out in the acts themselves that certain items of income are not included and certain expenditures are not deductible in calculating income. In practice, it can be said that the Federal income tax concept is a statutory conception of modified net income.

So-called unrealized appreciations of value are excluded from the calculation of income. Income must be realized by sale or conversion of assets; the emphasis is on income derived from capital. Realization does not mean that a cash basis must be used. Such a basis has not been required since the 1909 act; even under that act, it was not enforced in practice.

Periodicity must be considered in computing income for tax purposes, just as it is for accounting purposes. The law attempts to hold incomes and expenditures rigidly within separate periods. Matching of incomes and expenses is highly desirable, but frequently the law is arbitrarily and unfairly enforced as to its allowances and disallowances of certain items, on the grounds of periodicity.

The Federal income tax is founded on a realized, over-all concept of income. It is difficult to generalize about this matter, however, just as it is about almost any other thing connected with the income tax, because the law is filled with inconsistencies, both justifiable and otherwise.

The original general conception of income included regularity. This

idea of regularity has generally disappeared as income came to be recognized as any accretion in economic power; however, it has survived to some extent in the Federal income tax.[43] Inheritances and gifts are not taxed as income.

> Inheritances, for instance, are today scarcely anywhere deemed to be taxable income. From the point of view of the individual, however, they constitute income, even though it be accidental and not regular income. As a consequence they are now almost everywhere separately taxed, although not under an income tax law.[44]

Income is not limited to operating items, but includes income from whatever source derived. Certain items, such as gifts, income from governmental bodies, and so forth, are excluded on the grounds of expediency or social betterment. The entire tax concept is modified by expedient rules and by attempts to achieve certain social goals through the tax system.

This chapter up to this point has been devoted to an examination of some general ideas regarding economic, accounting, and income tax conceptions of the nature of income. Before going on to a discussion of the detailed provisions of the Federal income tax and of accounting standards, it is desirable that some logical basis of income determination be decided upon. The rest of this chapter, therefore, is devoted to developing criteria with which to compare accounting standards and income tax rules.

General Standards for Income Determination

A LOGICAL and coherent system of standards for income determination must be constructed if we are to judge the adequacy of income tax provisions for calculating income.

If the economic concept of income is modified to fit practical business conditions and difficulties, it becomes a concept which is, in reality, a logical accounting conception. Will the composite picture thus established be satisfactory for income tax purposes?

An affirmative answer is indicated. Since both economics and accounting deal with business, they should furnish the basic outline for determining taxable income. There appears to be sufficient reason for prescribing accounting methods, in general, for measuring income for tax purposes.[45] Caution must be exercised, however, not to assume arbitrarily that income tax methods must conform in their entirety with accounting methods.

Since a business enterprise measures its progress or retrogression by accounting methods; greater convenience, simplification, and cooperation will exist if taxable income is computed in the same manner rather than by an arbitrary or illogical statutory system. The methods followed by ac-

countants and business men are tied up rather closely with economic facts and conditions; the tax system, likewise, should be so related.

Both accounting and the tax system are faced with the difficulties inherent in an imperfect standard of value, the monetary unit. Neither one has yet been able to make much progress in overcoming such difficulties.

Although there has been some tendency on the part of the Securities and Exchange Commission and other government bodies to recognize the accountant and the generally accepted methods of accounting, so long as they are logical and measure income accurately,[46] the lack of agreement among accountants as to many things has slowed up such recognition of accounting practices for income tax purposes.[47]

The Regulations of the Treasury Department have specified that business and accounting methods are to be followed in determining income:

Article 182, Regulations 33, 1913:

No particular system of bookkeeping or accounting will be required by the department. However, the business transacted by corporations must be so recorded that each and every item set forth in the return of annual net income may be readily verified by an examination of the books of account.

Article 183, Regulations 33, 1913:

The books of a corporation are assumed to reflect the facts as to its earnings, income, etc. Hence they will be taken as the best guide in determining the net income upon which the tax . . . is calculated. Except as the same may be modified by . . . the law, wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to stockholders, should be the same as that returned for taxation.

Article 127, Regulations 33, 1916-1917:

. . . corporations keeping their accounts in strict accord with the methods prescribed by municipal, State or Federal authorities or in accord with approved standard accounting practices consistently followed from year to year, will be permitted to make their returns of annual net income on the basis of the accounts so kept, provided such systems of accounting clearly and correctly reflect the net income of each year.

The effect of this last provision is greatly diminished by Article 128, Regulations 33, 1916-1917:

Any system of accounting which is not consistent with the purpose and intent of the rules set out in this title, and with the general rules set out in these regulations for the ascertainment of net income, will not be accepted as a correct basis for making returns.

Article 323, Regulations 74, 1928:

It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required to make a return of his true income.[48]

No appreciable effect would be felt on government revenues if a more

logical system of determining taxable net income were used consistently. Even if some light decrease in government revenue were to result, businessmen should not oppose a moderate increase in rates to offset such a decline. A moderate rate increase would be compensated for by more certainty in taxation and by less expense for administration and preparation of returns.

Accounting, as it is at present, cannot be said to be entirely suitable for computing income for tax purposes. In fact, it is doubtful if there is any real uniformity in computing accounting income. In 1937, Carman Blough, then Chief Accountant for the Securities and Exchange Commission said:

> Because of the lack of agreement among accountants with respect to important accounting practices, it has been difficult for the Commission to determine what position it should take with respect to many statements involving controversial questions.[49]
>
> An examination of hundreds of statements filed with our Commission almost leads one to the conclusion that aside from the simple rules of double entry bookkeeping, there are very few principles of accounting upon which the accountants of this country are in agreement.[50]

We must not assume that this is merely the opinion of a public official antagonistic to private business, because Mr. Blough later became a practicing public accountant. The situation has been described well also by Mr. Howard Greer, another prominent accountant:

> Any extensive study of corporation financial statements will disclose the fact that there are widely divergent and unnecessary differences in practice in treating identical items. It is to these divergences and differences that I believe the public accounting profession in this country may well direct its attention in future years.[51]

The above statements by Carman Blough and Howard Greer are by no means isolated opinions. Rather, there appears to be some widespread feeling that the field of accounting is haphazardly, incoherently, and illogically developed.[52]

Lack of uniformity is a suitable ground for complaint when it is found in the most basic standards and assumptions on which accounting theory and practices are founded. Without solid moorings to which to anchor, accountants are bound to drift and to produce surprisingly inconsistent results and calculations.[53] Such inaccurate and widely divergent calculations are not objective and correct enough to be used as a suitable basis for an income tax.

The adverse criticism of lack of uniformity is not aimed at all detailed procedures, because, obviously, some choice between detailed methods which arrive at approximately the same amount of income is permissible.[54] Accounting is not a field of precise action, and income is not a figure which can be arrived at with complete accuracy. Judgment and opinion

play a large part in its calculation.

Perhaps some of the difficulties encountered in trying to formulate a rational system of determining accounting and tax income and for reconciling the two have grown out of the misguided endeavor to provide rules for even the most minute details. An attempt should be made to establish general standards and to require proof and justification for divergences from such standards.

For some years now, the American Accounting Association, the American Institute of Accountants, and a few individuals have tried to formulate statements of accounting principles that could receive general acceptance. These efforts, although they have not been entirely successful, have been commendable, since they have focused attention on the shortcomings of accounting theory. None of these statements has been very widely accepted by accountants, however. In fact, some have expressed doubts as to whether there are principles of accounting or not.

Even though accounting theory is in a confused condition, it is far better organized than the rules of contemporary practice.

With accounting theory and practice in such uncertain condition and the very existence of accounting principles in controversy, it might be unreasonable to demand that tax methods of computing income be required to conform to generally accepted accounting principles.

It is beyond the scope of this paper to endeavor to reconcile and discuss all existing practices and statements of principles in an attempt to formulate anything which can be said to be generally accepted. However, if there is no basis for judging the adequacy of either accounting or tax practice, how can we decide the relative merits of either method?

The solution requires the formation of a rational and consistent concept of income and a system of standards for measuring it.

Even though differences are found between income tax provisions and the standards set up as criteria, it must be remembered that some of these divergences are to be excused, even encouraged, in the interests of effective administration, justice, and the furtherance of social aims. Just how much the tax system may be affected by social goals is a matter for dispute, however.

Since the accounting method of determining income is quite satisfactory in general, for figuring income for tax purposes,[55] a rational system of accounting standards must be devised. In order that a coherent and consistent system of accounting standards may be constructed, it is necessary that it be built around the function which accounting serves.

DR Scott says that accounting has three principal functions and ranks them in importance in the following order: (1) protection of equities, (2) management control, and (3) maintenance of record.[56]

If accounting has several goals, perhaps it is possible that several sys-

tems of accounting standards might be constructed, each of which would be usable only within the specific limits contemplated by each goal to be reached.

If this variable situation is to exist, which system of standards shall be used for taxation of income and which shall be used for any one of the many other situations which require the measurement of income? Clearly, competing systems of standards would create chaos; perhaps much of the present confusion in accounting has arisen because no truly primary function of accounting has been discerned by most accountants.[57]

In discussions of function there is a tendency to confuse central purpose with possible uses. The uses to which accounting data may be put are many and diverse; obviously, principles and procedures cannot be oriented equally well to all uses, nor can each use have its own set of principles and procedure.[58]

The classification of functions as protection, management, and record may be criticized adversely in the light of the above statement. These three are possible uses of accounts which have been founded on one general purpose. That general purpose must be broad enough to support an all-inclusive system of standards which can have no competitors.

Perhaps, the most satisfactory concept of the function of accounting to be used as the basis for a well-rounded system of standards for income determination is that accounting is designed to furnish dependable financial information about a business enterprise that will satisfy the needs of all parties at interest and that will be continuously in accord with a single, coordinated body of accounting theory.[59]

If the protection of equity and management control ideas are discarded, many of the possible reasons for introducing values into the accounts are eliminated. Emphasis is shifted from a balance sheet to a profit and loss point of view. If the dependable information conception is adhered to, a definite requirement is made that only objective information is to be used.

A large volume of opinion supports the idea that costs and not values should be used in the accounts,[60] but it must be admitted that some of those who hold the cost view, and most accountants, appear willing in practice to permit expediency to creep in and to allow the use of other than cost for certain things and under certain circumstances.[61] Most of those who allow the use of other than cost limit such latitude to current assets.

Some favor the complete elimination of adherence to purchase price in the accounts.[62] The support for this view is generally encountered in those who conceive of the purpose of accounting as management control or the protection of equities.

A cost basis for accounts is criticized unfavorably sometimes on the score that changes in the general price level are buried in cost figures

and that no accurate calculation of income is possible if costs incurred at different general price levels are used together in computing income.[63]

If the income concept for accounting and tax purposes is *increased control over wealth,* a theoretically accurate computation of increased control over wealth requires that net return expressed in terms of money's worth must be adjusted by the amount of money's worth which merely compensates for a change in the general price level. In other words, a true net income concept requires that the income not only be in excess of expenditures, but that there be a true accretion in economic power.

There is merit in this objection, but index numbers and other devices have not been developed fully enough yet to be suitable for use by accountants in adjusting their income calculations.

Objective data, those which are capable of independent verification and which are free from subjective valuation, are the most suitable on which to erect a system of income determination for tax as well as accounting purposes. Mere conservatism has no place in the determination of income for tax purposes on an objective basis.[64]

Administration of a law which permits subjective considerations to creep in is almost impossible, if inequalities and evasions are to be kept down to a minimum. The conception of the function of accounting which requires dependable information is, therefore, the most satisfactory upon which to erect our accounting standards if they are to be acceptable also for income tax purposes.

The most suitable concept of income for income tax and accounting purposes is the *net realized increase of economic power from all sources, measured in terms of money between two points of time, excluding additional investments and withdrawals of capital.*

CHAPTER III

PERIODICITY

INCOME IS THE NET ACCRETION to economic power between two points of time, excluding, of course, withdrawals and additional investments.[1] From an ideal standpoint, income should be computed for the entire period of existence of a business entity.

The practical concept of income formulated in Chapter II specified that the computation of income was to be made for arbitrary periods of time shorter than the full life of the business enterprise. Such periodic calculations are necessary to satisfy the demands of those interested in a business for current information of its conduct and progress. Tax administration and government financing also require short term calculations of income and periodic tax collections.

If income were calculated for the entire life-span of an enterprise, there would be few difficult problems to face. The assets on the opening balance sheet could be evaluated, totaled, and compared with the money on hand after realizing on all of the assets and after liquidating the liabilities. These figures could then be adjusted for the relative purchasing power of the capital originally invested as compared with that which remained after liquidation. The difference would be income, i.e., the net accretion to economic power.

Matching

THE INTRODUCTION of periodic calculation has made it necessary to chop off segments of gross income inflow and to match them with those items of expenditure which can be said to be related to the inflow.

This matching device is quite obvious for operating inflows and outflows. There usually are some inequalities between the outflows and their related inflows; the result is either gain or loss (net positive or net negative income). There may be outflows made with the intent of inducing inflows but which have missed their mark entirely; these are also operating losses.

The matching procedure for non-operating recurrent items is a bit more difficult to use. For example: the outflows related to inflows of interest and dividends received by a corporation can be traced indirectly to the dividends or interest paid to the suppliers of capital to the corporation which has received the interest or dividend inflow in question. Objection may be raised that dividends paid are not an expense and, therefore, can not be considered an outlay, in the nature of an expense, made to induce a revenue inflow. If the theory that a corporation is a business

entity apart from its shareholders is accepted,[2] distributions of income made to any equity can be considered in the nature of expenses for the use of capital.

Since particular equities can not claim particular assets, if there are any capital contributors (such as short-term accounts payable) not entitled to interest or dividends, the assets they contribute may be considered to be used (on a *pro rata* basis with the assets contributed by the other equities) by the corporation for the investments which are the source of the dividend or interest inflow. To the extent that such short-term contributors, or others, are financing the corporation without a return for their services, the dividends or interest received by the corporation may be said to be inflows, similar to gifts, not matchable with outflows. Inflows of dividends or interest are, therefore, only partially subject to the matching process.

The non-payment or deferment of interest or dividends by the recipient corporation to its own equities causes no difficulty in reasoning regarding the matching operation. Such outflows are merely deferred outflows and theoretically should be accrued as expenses to be matched with inflows. This general procedure is now used in the case of interest payable but not for dividends. Dividends are not accrued, because generally they are not considered expenses. This differentiation between interest and dividends is based on emphasis on the idea that shareholders inherently represent a proprietorship equity quite different from other capital-contributing equities.[3]

Ultimate non-payment of dividends by the corporation does not, in itself, negate the idea that such dividends are expenses, because a comparable situation arises when any accrued expense liability is left unpaid.

Finally, this matching concept adapts itself also to non-recurring, non-operating inflows. For example: we match what we receive on the sale of a fixed asset with the book figure for that asset disposed of. The difference is a net inflow or net outflow. An apparent exception to such matching is found in the case of gifts received. There appears to be no offsetting outflow for such items. Non-recurring, non-operating outflows can not always be matched with inflows, either. A ready example is an outflow occasioned by fire or other destruction.

To summarize the subject of matching:[4]

Operating inflows can always be matched with operating outflows to some extent. Operating outflows may not always be matched with operating inflows.

Recurrent, non-operating inflows can not always be matched with outflows; nor can recurrent, non-operating outflows always be matched with inflows.

Except for items in the nature of gifts, non-recurrent, non-operating

inflows can be matched with outflows. Non-recurrent, non-operating outflows are not always matchable with inflows.

Matching is put into operation by means of accruals and deferments in order to bring related inflows and outflows into the same arbitrary income-calculation periods.[5]

From a theoretical viewpoint, it is not important whether we match the incomes (by deferring or accruing them) with the expenses or whether we match the expenses with the incomes. From a practical point of view, the incomes are less easily recognized than are expenses, and the matching of them with expenses might be risky in that the income might never come into being; outflows do not always cause inflows. It is easier to accrue expenses and to relate them with ascertained incomes, because expenses are more predictable and subject to control and forecast.

From the tax standpoint, the matching of incomes against expenses might be inexpedient, because in many cases a taxable income computed thus would not carry with it the ability to pay taxes.

Care must be exercised to prevent distorting matching into a device for showing artificially stable income figures.

Neither the conception of income as a stream nor the accrual theory of accounting implies that calculated periodic net income will be regular and even in amount. The accounts therefore should not be distorted or artificially stabilized in order to cause the income statements for a series of periods to report a smooth flow of net income.[6]

Accrual Basis for Income Determination

RECOGNITION of the accrual method[7] of accomplishing the matching of inflows and outflows of assets is widespread and of long standing in the field of accounting.[8]

The only known method of applying all expenses, costs, and charges to the gross income which arises from the use of the charges is to record the costs in the period in which they belong. This is known as the accrual method.

Under the accrual method everything which belongs in an accounting period is thrown into that period. Conversely, every transaction in one period which affects the income of an earlier or later period is thrown out.[9]

The Revenue Act of 1909 required the cash basis of accounting for income. An immediate protest was made by accountants, and the law was administered so as to permit the use of the accrual method instead.

There appears to have been some doubt as to the intent of the Revenue Acts of 1913, 1916, and 1917.[10] In an attempt to clear up the uncertainty, the Treasury Department stated that the words "paid" or "actually paid":

. . . does not necessarily contemplate that there shall be an actual disbursement in cash or its equivalent. If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly allocated even though not actually disbursed in cash, provided it is

so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis.[11]

If in the course of its business, a corporation credits the accounts of individuals, firms, or corporations with the amount of any expenses . . . due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred are vouchered in definite amounts, the amounts so credited or vouchered may be treated as paid, and if the amounts so credited or vouchered are expenses incurred concurrently with and in the production of the income of the year, they may be allowably deducted therefrom.[12]

All expenses . . . incidental and necessary to the creation or production of the gross income or properly charged against the same, being deductible from the gross income whether paid in cash or entered on the books as a liability, cannot, if unpaid, be carried forward to be deducted from the gross income of a subsequent year.[13]

This 1916-1917 Article was incorporated into Section 200 of the 1918 act, which stated:

The term "paid" for the purpose of the deductions and credits under this title means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under Section 212.[14]

The acts of the succeeding years have contained provisions substantially similar in nature.[15] However, in 1924, a phrase was added in Section 200(d), which materially weakened the announced position of the Treasury in regard to accrual accounting, and is perhaps the cause for some deviations between accounting and tax provisions. This phrase was: "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."[16] Underlying this provision was Section 234 (a) (4) of 1921, which authorized the Commissioner to deduct losses in a year other than that in which sustained, if necessary to reflect income clearly.

The regulations and sections of the acts regarding paid, paid or accrued, and paid or incurred were made necessary by the relatively poor way in which the 1913 act was drafted. This clarification that accrual accounting was intended was required, because the 1913 act was, in large measure, a restatement of the 1909 law, a law which was drawn up to require a cash basis of income calculation.[17]

Further evidence of the intention of the Treasury to make matching, hence to allow accrual accounting, fundamental in the computation of income, can be found in the 1913 and subsequent regulations[18] regarding cost of materials.

Article 123, 1913:

In ascertaining expenses proper to be included in the deductions to be made under the item of "Expenses," corporations carrying materials and supplies on

hand for use should include in such expenses the charges for materials and supplies only to the amount that the same are actually disbursed and used in operation and maintenance during the year for which the return is made.

And Article 130, 1916-1917 added:

If a corporation carries materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the corporation to include in its expenses and deduct from gross income the total cost of such supplies and materials as were purchased during the year for which the return is made.

In 1921 and subsequent years the word *incidental* was inserted as the fifth word in the first sentence of the above quotation. In 1918, additional words were added to the last sentence; they were: "provided the net income is clearly reflected by this method." The latter portion of Article 130 is merely a recourse to the cash basis, but perhaps the phrase added in 1918 would prevent the handling of inventories on a cash basis when the balance of the accounts are on an accrual basis.

On the surface, it appears that the Federal income tax acts permit matching of inflows and outflows by the use of accrual accounting, but many of the differences which have arisen between accounting and income tax methods of computing income can be traced to a difference in the manner of handling accruals. The Treasury Department has even been accused of arbitrarily allocating incomes and deductions incorrectly in order to circumvent the statute of limitations set up relative to amended tax returns.[19]

We can judge the extent to which the income tax method for handling accruals differs from that found in accounting by examining the regulations and court decisions regarding the time element used in matching up individual items of gross income with their related expense.

The Regulations are quite specific that, in general, strict periodicity in accruing and matching incomes and expenses is required. Article 127, Regulations 33, of the 1916 and 1917 acts provided that: "The expenses, liabilities, or deficit of one year can not be used to reduce the income for a subsequent year." Regulation 45 of 1918 stated:[20]

Each year's return, so far as is practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. . . . The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes, or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount

paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement, or otherwise, is deductible from gross income when the claim is put in judgment or paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. . . .[21]

Almost identical Articles are included in the Income Tax Regulations at the present time, and in those for the intervening years.[22] In 1921 and subsequent years, losses from theft and embezzlement are deductible in the year *sustained,* rather than in the year of *occurrence* as in 1918. The significance of this change is doubtful, but it may be interpreted as a very slight relaxation of a rather rigid rule.

A more important alteration of the law subsequent to 1918 is the inclusion of an additional sentence, as follows:

It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deductions, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts.

There are few persons who would find cause for objection in the above sentence. It violates absolute theory, perhaps, but it does not alter materially the income calculation. This concession on the part of the Treasury away from strict adherence to periodicity is limited to those items which are recurring and which tend to offset each other. In order that the offset may work, consistency in treatment is required and is absolutely necessary. Consistency has also been insisted on in several cases by the Board of Tax Appeals and the courts[23] and also by accountants.[24]

The provision in Article 111 of Regulation 45 of 1918 regarding the non-deductibility of expenses belonging to prior periods is sound. If the tax authorities were to be lenient in the matter, all sorts of irregularities and evasions could be practiced by taxpayers by taking deductions when it would be most to their advantage to do so. Any attempts at smoothing out income for a period of years should be handled through loss carry-over provisions.

The Regulations provide limited relief to the taxpayer in the form of amended returns and recalculated taxes for prior years in which adequate deductions were not taken. Unfortunately—although, from an administrative standpoint, necessarily—a statute of limitations seriously prevents complete restatement of all prior periods which were in error.

In the Regulations pertaining to the 1916 and 1917 laws, additional

emphasis is placed on the proper method for correcting errors in the calculation of income.

. . . if it does not within any year pay or accrue certain of its expenses . . . and makes no deduction therefor, it can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities.[25]

Ample support can be found for this position in other Treasury rulings and in court and Board of Tax Appeals decisions.[26]

Similar decisions have been made in regard to the inclusion of income within the proper period. The fact that income was incorrectly included in a prior year does not justify excluding it in a later year when it is properly taxable,[27] nor claiming it as a deduction in a subsequent year.[28]

Contrary to this position of more or less rigid periodicity in the income tax can be noticed a trend among accountants toward including all corrections of past periods' income in the current profit and loss statement instead of in surplus.[29] This situation should not be considered too seriously as the basis for adverse criticism of the tax when we are comparing accounting calculations of income with those provided for income tax purposes, because different and graduated tax rates of different years must be taken into consideration.

Those who favor such treatment usually specify that a special section be provided in the profit and loss statement for such items, in order to keep them separate from current figures. The intent of such inclusion is to make it possible to obtain a picture of total accumulated income for an enterprise merely by assembling all profit and loss statements for the periods involved.[30] This device is intended as a practicable alternative to drawing up amended profit and loss statements for prior periods, although amended statements are considered by some as ideal treatment, as is the case under the Federal income tax.[31] It must not be inferred, however, that there is complete agreement as to the desirability of amended statements.[32]

In addition to these rules regarding correction of errors of prior periods, certain other regulations and decisions have been issued concerning matching for income tax purposes. Some are in agreement with that which accountants feel is correct; others are in contradiction.

The earlier income tax treatment appeared to treat accrued items as items which have become due.[33] In other words, an actual liability had to be incurred before an accrued expense might be used or an actual asset had to be receivable before an income might be taken up. The emphasis was on legal form and title; the wider accounting view of matching, which may in fact be necessary before actual legal rights are affected, was overlooked.

However, it should be noticed that the usual accounting rules which

require the use of sales or other verifiable events as the point at which to recognize a gain or a loss on the disposal of property are quite similar to the above type of income tax provision for the treatment of accrued items.

Definite evidence of this attitude regarding accruals is found in 1922 in the following Income Tax Unit rules:

There must be an actual liability incurred before an amount may be accrued. Where a liability has actually been incurred and is uncertain only in the actual amount necessary to discharge it and the actual date at which it must be discharged, an amount representing a reasonable estimate of such actual liability incurred may be set up as an accrual and will constitute an allowable deduction for Federal income tax purposes for the taxable year in which such liability was actually incurred. Where a liability is not to be incurred until the happening of some contingency, such contingency must happen before there is, of course, a liability actually incurred, and prior to such time no amounts can properly be accrued in respect thereof for income tax purposes.[34]

. . . in order to be accruable in the taxable year for which a return is made, a valid right to income must have arisen or existed in that year, which is enforceable on the date the income is due. If, however, the right to an amount is contingent upon the happening of some future event, there is no certainty that it will be paid or will accrue. In this event no income accrues from a fixed and determinable source, and no right to anything arises or exists in the taxable year which can be accounted for as income under any system of accounting.[35]

A later decision, made in 1926, by the Supreme Court included a broader view of *accrued*:[36]

In a technical sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of taxpayer to it. . . . In the economic and bookkeeping sense with which the statute and the Treasury Decision were concerned the taxes had accrued.[37]

Other decisions were handed down in 1926 which were in agreement with the above decision[38] and appear to overrule previous decisions of the Board of Tax Appeals.[39]

A satisfactory decision was handed down, in *Mobile Drug Company v. U.S.*,[40] to the effect that a deduction accrues when the conditions happen on which it depends and not when the evidence becomes available to prove these conditions. This merely supports the regulations already discussed. If evidence of an expense or loss comes to light in a subsequent period, proper treatment requires amended returns for prior years rather than adjustment in the current return. The cash basis for determining income is based on the idea of entering an item only when more or less definite evidence, in the form of cash, is present. When the conditions happen is not always evident in the case of losses. A discussion of possible accruals of losses is included in Chapter V—Non-Recurring Items.

The trend in decisions is in the direction of a better conception of the

meaning of accrual. This trend is not a reason for too much optimism, however, because there has been some vacillation in the rules and decisions promulgated about and since the time of this group of decisions.

In 1925, a satisfactory decision was handed down to the effect that if a taxpayer kept his accounts on an accrual basis and purchased supplies for future periods as well as for a present year, some of the supplies should be deferred and deducted from the gross income of the year in which the supplies were used.[41] A similar decision was made a few years later in which the accrual basis of accounting was required for a steamship company which sold cruise tickets in one year and incurred related expenses in a subsequent year.[42]

The matter of treating prepaid subscriptions for income calculation on an accrual basis has also been the cause of some confusion under the income tax. G.C.M. 20021 held that receipts for prepaid subscriptions were income regardless of when they were earned, provided the amounts were received without restriction as to use or disposition. This rule has been limited to a particular case, however (a case in which the taxpayer, although on an accrual basis, had consistently taken up income when received), because the general effects of G.C.M. 20021 have been removed by a later special ruling of the Bureau of Internal Revenue.[43]

Shortly thereafter, the Board of Tax Appeals again recognized the real nature of accruals when it held that 1920 earnings were 1920 income on an accrual basis, even though the amount was not known until 1921.[44]

This series of satisfactory decisions was broken in 1930 in a case in which the Board of Tax Appeals decided that for a taxpayer on the accrual basis, who received fees on an annual basis as well as for a three-year period, all fees collected were income when received.[45]

In 1939, the view of accrued as *has become due* was again rejected as it was in 1926 in the *Yale and Towne Manufacturing Company* case. In the more recent issue,[46] the Board reversed the Commissioner's disallowance of accrued property taxes; there were two dissenting votes, however.

In spite of the above trend of court decisions, statutes, and regulations, in 1939, the Bureau of Internal Revenue still adheres to the legal idea of accrual as *has become due* in the case of taxes. The Bureau selects a date at which taxes are said to become a liability and overlooks proper accrual. The Board of Tax Appeals has reversed the Bureau and upheld proper accrual, and cited *U.S. v. Anderson.*[47]

> The striking feature of the position of the Bureau . . . is that it will not in the long run, produce . . . additional revenue . . . it upsets the accounting practices of taxpayers, causes them considerable unnecessary annoyance and expense; and on occasion leaves an unwary taxpayer with a deduction disallowed as applicable to prior years for which no refund can be obtained.[48]

Reserves

THE PROPER USE of reserves forms an important part of the accrual basis for matching expenses with their related incomes. Certain reserves are indicative of accumulated deductions from gross income for expenditures made with the intent of obtaining income.

Expenses accumulated by the reserve method are allowable, just as in the case of all expenses, only to the extent that Congress is willing to allow them.[49]

Reserves may be classified into two major groups: (1) accrued or accumulated expenses[50] (including loss reserves related to operations)[51] and (2) segregations of surplus.

The latter type has nothing to do with income calculation. It is composed merely of book entries made to classify income accumulated from prior periods. Surplus reserves are not considered in either accounting[52] or income tax calculations of income.[53]

One accounting authority has expressed the matter thus:

> It is generally recognized that the past period should be charged with only so much loss as is in prospect as a result of declines which have actually taken place. Therefore if provision for additional loss is to be made, it must be made out of surplus. . . . As the loss has not yet taken place, the reserve is a part of the surplus. . . .[54]

In several decisions, so-called depreciation charges on leased property were correctly considered surplus allocations and were disallowed.

It is difficult to classify self-insurance reserves as surplus reserves or operating reserves.[55] If they are surplus reserves, the charges therefor should not be deducted from income; and under the Federal income tax, they are considered non-deductible provisions for future losses.

There is no unanimous agreement among accountants as to the nature of a self-insurance reserve. Some believe it is an operating item;[56] others, an allocation of surplus for mere contingencies.[57]

The provision for self-insurance reserves is not deductible for the Federal income tax. In 1913 it was stated:

> Funds set aside by a corporation for insuring its own property are not a proper deduction, but any loss actually sustained and charged to such fund may be deducted.[58]

The terminology in the above quotation is poor; *reserves* and *funds* are confused. In 1916-1917, an attempt was made to clarify the matter by adding the following words after "fund" in the last line: "or reserves, if such funds are set aside, or a reserve therefor is set up."[59]

This early provision has been supported many times since then in Bureau, Board, and court decisions. Additions to reserves for self-insurance equal to estimated premiums payable to life insurance companies

have been held not deductible, even though the risk was so great that no insurance could be obtained.[60]

In using reserves, care must be taken to prevent artificial leveling of net income figures. Such stabilization is approved in neither accounting[61] nor income tax calculations of income.

In an effort to prevent such distortion of profits, it has been held for income tax usage that before an accrual of expense may be charged to income, an actual liability therefor must exist;[62] a reserve for a liability which merely may arise in the future is not deductible.[63] It has not been required, however, that the actual amount and date of discharge be known; a reasonable estimate of such liability may be set up.[64] Accountants agree that reserves for known losses which will occur, although the amounts may not be certain, are often as accurate and certain as are estimates of depreciation, obsolescense, and like items.[65]

As far as the income tax is concerned, it has been fairly well established that deductions may not be taken for losses which are mere possibilities and which are contingent on the occurrence of later events.[66] The official view of the matter was expressed clearly in the *Farmville Oil Fertilizer Company* case:[67]

> That a reserve for inactive contingencies such as possible repayments, price discounts, or price rebates, the amounts of which have not been fixed or fairly susceptible of ascertainment prior to the end of the taxable year in question, is not the basis of a statutory deduction has now become a settled doctrine.

The line between mere contingency reserves for future losses, expenses, or liabilities and present expenses which are settled by future disbursements is difficult to distinguish. The guiding rule should be to match the incomes and related expenses. Expenses which have benefited or which represent assets expired in a given period should be allocated to that period by accruing or reserving. Perhaps, if the word reserve were omitted and accrued were substituted, less misunderstanding would arise.

Many accountants do not adhere to this matching procedure, however, and introduce into current income calculations future losses not applicable to present operations.[68] They do this in the interests of conservatism, often misguided. Conservatism may be commendable in some cases, but it often results in misstated income calculations. There is no very valid reason why taxpayers should expect the Treasury to tolerate guesses which reduce taxable income, merely because the taxpayer is trying to be conservative; most taxpayers are not willing to be taxed on guesses regarding unrealized incomes. Perhaps this is one place in which income calculations for tax and for general business purposes may legitimately differ. But, even here, conservatism can be introduced by the businessman by surplus reserves and not by reductions of current income figures.

Following a great host of decisions,[69] it has become settled that reserves

for anticipated future expenses or future losses are not deductible, even though the accrual basis of accounting is followed. The allowances for obsolescence and bad debt provisions are apparent exceptions to the rule.[70]

If these future expenses are pure contingencies and the reserves therefor are surplus reserves, there is little objection to the income tax decisions; but some legitimate accruals have been disallowed.

> Perhaps the most palpable variance between actual net income and Treasury net income lies in the charges against income which are certain in effect but uncertain in amount.[71]

It may be that inaccuracies attendant on such estimates are so great that income computed after allowing such indefinite deductions would not be a suitable tax base.

The difficulty of measuring such accruals has been mentioned even by one who is a staunch advocate of such deductions.

> When we speak of allowances for probable losses we force ourselves into the position of prophets who must translate the future into the present. We set ourselves an impossible task and then proceed to do it the best we can.[72]

In spite of the fact that a prospective disbursement of assets can not make a future expense out of an item now related to current income, many income tax decisions have held that such items are non-deductible.

In a group of cases, reserves for future maintenance of construction work have been disallowed, although the income on such work has all been taken up currently.[73] Provision for such maintenance work is a proper deduction from current income, either as a present expense or as deferred income. If adequate records and computations are presented to support such items, the deductions should be allowed.

Several other sets of cases similar to the construction cases were decided against the taxpayers. In each case income was not permitted to be deferred, nor were anticipated expenses under contract permitted to be deducted.

In several cases involving cemetery companies, reserves for maintenance were disallowed and the entire gross income received was held subject to tax. The deciding factor appeared to be that when amounts were added to such reserves similar sums were not also segregated in distinct maintenance funds.[74] These decisions appear to confuse reserves and funds. Contributions to funds have no bearing on income calculations.

The confusion of the court is evident in the following statements:

> Under the oral contract petitioner was under no restriction, contractual or otherwise, as to the disposition, use, or enjoyment of the fund.[75] [and:] Moreover petitioner has treated the entire amount herein involved as income by using it for purposes not contemplated by the trust, which it agreed with its lot

purchasers that it would not do, and by failing to establish the fund which it agreed to establish, and it therefore is not in a position to ask the court to use it for the purpose of avoiding taxation by considering the thing done which it has itself continuously failed to do.[76]

The court, in these two cases, has set up a test which has no meaning for income calculation. It is a test which it does not apply to accrued wages, salaries, or any other accrued liability; in none of these cases is it required that an offsetting fund be set up. The disposition of assets does not determine income.

In the 1926, 1928, and 1932 laws,[77] a concession was made to permit a reasonable allowance for future expense liabilities in the case of casual sales or dispositions of real property. This provision might well have been extended to all types of income, casual or otherwise, in order to allow matching to be used more fully. The privilege granted was subject to the limitations included in the following quotation from the 1926 provision:

In the case of a casual sale or other casual disposition of real property, a reasonable allowance for future expense liability incurred under the provisions of the contract under which such sale or other disposition was made, under such regulations as the Commissioner, with the approval of the Secretary, may prescribe, including the giving of a bond, with such sureties and in such sum (not less than the estimated tax liability computed without the benefit of this paragraph) as the Commissioner may require, conditioned upon the payment (notwithstanding any statute of limitations) of the tax, computed without the benefit of the paragraph, in respect of any amounts allowed as a deduction under this paragraph and not actually expended in carrying out the provisions of such contract.

This provision was not included in the 1934 act, because it was felt that other sections covered the matter adequately.

Prior to the 1926 provision, similar rules applicable to all sales of real estate were laid down in a number of decisions,[78] one of which stated:

It is well established that as a matter of law the petitioner has the right to include in its cost such estimated future expenditures for the development of the property as required by its contract of sale.[79]

Other taxpayers sold service contracts to customers, in which they agreed to repair their automobiles for a given period of time. Even though they were on the accrual basis and took up the gross amount as income, the taxpayers were not permitted to deduct reserves for future services to be performed.[80]

As recently as 1938, this type of unsatisfactory disallowance of reserves necessary for proper matching has been made in Treasury rules. In this case a publisher who collected long-term subscriptions in advance was required to report the gross amount when received. No allowances were made for the related expenses necessary to fulfill the agreement (paper, print, labor, delivery expenses, etc.).[81]

Another controversial type of reserve is one that can be estimated accurately within the experience of the business and be set up to provide for recurring future losses which are associated with current operations and income.[82] This type of reserve does not cover future events which are merely uncertain contingencies properly reserved from surplus. The deduction for this sort of thing is based on a risk-cost theory of loss.

If there is a cost factor whose incidence is irregular, like the loss from industrial accidents suffered by manufacturing enterprises, cost accounting undertakes to spread it over all operations. The justification offered for this practice is that the cost chargeable to a given product is the risk of loss attaching to the operations which resulted in the product, rather than the loss suffered in accidents which chanced to occur in those operations. The operations for a given period may show no accidents, but it does not follow that those operations have carried no risk of accidents. If the cost accountant neglects this risk, he is not showing an accurate coordination of costs and incomes.[83]

Accident experience is practically as certain as any other expense and when the employer assumes the attendant risk there at once arises a liability—certain as to the event, contingent as to the amount. Experience—not stipulated premiums—is the practical basis for finding that contingent amount.[84]

This theory of charging income with all actual and prospective operating losses has gained favor among accountants.[85] Among reserves for such losses are included reserves for pensions,[86] income taxes,[87] predictable accidents,[88] self-insurance,[89] predictable losses on guarantees,[90] and repairs.[91]

In general, the income tax has not allowed losses occurring in the future, even though they are related to current taxable income.[92]

A reserve for legal damages expected to be awarded against the taxpayer was disallowed; emphasis was placed in this decision on the absence of a legal liability at the time of accrual.[93] A reserve for expected losses from patent litigation has been held not deductible. The actual amount is deductible in the year in which the decision is final and payment is made.[94] An opposite decision was arrived at in several Board of Tax Appeals cases of earlier years.[95] In those cases, the taxpayer reported on the accrual basis and set up a reserve to cover estimated liability for breach of contracts incurred in the course of business. The liability was determined and paid early in the subsequent year, but the taxpayer was permitted to deduct in the year of breach the amount of damages subsequently paid.

Among other such reserves which have not been permitted to be deducted are reserves for the following: return of unsold magazines,[96] cost of audit of current year's accounts to be performed in the succeeding year,[97] cost of collecting bad accounts,[98] sales commissions which are dependent on collection from the customer to whom sale was made,[99] repairs,[100] cash discounts,[101] and returns and allowances.[102]

A better situation exists in regard to accrued reserves for the redemp-

tion of trading stamp liabilities. In 1931,[103] such items were disallowed, but in 1932[104] and 1937[105] it was ruled that such items were accrued liabilities and were deductible if properly based on experience. Permission for the subtraction on a liability for redemption of trading certificates was granted in the Regulations of 1932 and subsequent years.[106]

Long-Term Income

THE UNDESIRABLE consequences of periodicity in certain cases have been recognized by those who advocate plans for averaging taxable income, for carrying losses forward, or for presenting cumulative statements of income.[107] The concept of income underlying such schemes is a long-term, full-life rather than an annual conception.[108]

Recently some sentiment has arisen among accountants for preparing profit and loss statements[109] which show all income and income-reducing items, even though they are not altogether related to the particular period for which the calculation is being made.

An attempt to deal with extraordinary gains and losses on an annual basis has caused many tax difficulties and inequities. Not much success has been had in applying accrual methods to such items, either. Yet, unless matching methods are used, lump gains or losses are taken in the year in which the extraordinary inflow, and in most cases the arbitrary outflow also, occurs. A haphazard basis such as this invites manipulation by taxpayers and arbitrary and inequitable rules and limitations by the Government.

Plans for averaging income for several periods or for carrying over losses to other periods have been suggested to get around this difficulty in matching. There is a great deal of justification for special tax treatment of extraordinary gains and losses, because they are not easily predictable or readily accruable and because they are recognized suddenly in lump sums. Undue distortion arises when such gains or losses are thrown into the taxable income of one year, because of progressive rates of taxation. Schemes for complete adjustment of the income of past periods are usually not administratively feasible.

The use of average or carry-over schemes is not a complete rejection of periodicity. To the extent that ordinary, recurring items are allowed to be averaged or carried-over, periodicity is rejected. There is no such rejection in so far as these methods are an attempt, however crude they may be, to apply matching to situations which lack the necessary predictability to make ordinary accrual methods readily workable.[110]

This attempted spreading out of extraordinary gains and losses does indicate, however, a renunciation of the idea that there is anything inherently different in capital gains and losses from that which is found in the more stable forms of incomes and outgoes. It does involve recog-

nition, moreover, that the sale is not entirely satisfactory as the point at which to measure income realization.

The use of averages in computing and taxing income remedies much of the difference in results achieved by determining income on an accrual as contrasted to a cash basis.[111]

Average Income

THERE HAVE been no provisions in the Federal income tax for using average income,[112] as such, as the basis for taxation, but methods of averaging have been tried in Wisconsin and in North Dakota. Most state income tax laws ignore such devices because of the necessary administrative difficulties involved.[113]

In 1927, Wisconsin adopted a three-year average method. The tax rate of any given year was applied on the average income for the three preceding years. Although this plan had a stabilizing effect on tax revenues, in 1931 it was repealed, effective in 1934. The principal objection to the plan was that ability to pay and the time for payment of the tax might not coincide. There might be a large income in the first of a series of years and none in the next two, yet the taxpayer would be forced to pay in the latter years a tax based on the average.[114]

Some plans have been devised to overcome this lack of ability to pay, but there is some doubt of administrative practicability. One elaborate plan of this nature has been devised by Martin Atlas.[115]

Another device has been suggested which is similar to the carry-over and the average plans; it is a cumulative income tax. The organization of it would follow somewhat that of the Federal gift tax. It could be operated on a cumulative basis for the full life of the taxpayer, as is the gift tax, or it could be cumulative for the duration of an entire business cycle or other series of years.

North Dakota has already put into operation a form of cumulative income tax.[116] It provides for complete deduction of prior-year losses; such losses may be deducted from the profits of current years until such time as the total of the operations over the entire period represents a profit.

Carry-Over of Losses

LOSS CARRY-OVER schemes have had their place in our income tax law, but have not always been thorough-going and have been the target for much criticism throughout the period of the income tax.

The 1909 act was criticized adversely by those who held a long-range view of income,[117] because the privilege of loss carry-over to the next year with a net revenue was not granted the taxpayer.

In 1934, Magill, Parker, and King presented a report based on their

study of the British income tax. They found that losses under the British system may be carried forward for six subsequent years, and:

Furthermore, such business losses may be used not only to offset subsequent business gains, but may also offset income from lands, from interest, and from other miscellaneous sources for the same year as the year in which the loss is incurred. From the point of view of equity, there is much to be said for the British system, although it is evident that the revenue must be adversely affected.[118]

Corporations with widely fluctuating earnings (most durable goods industries) have suffered by reason of limited carry-over provisions, as contrasted with those having steady earnings. The *Business Bulletin of the Cleveland Trust Company*, May 15, 1937, stated that for the years 1918 to 1934, 39 per cent of the income of the lumber and wood products industry was absorbed by Federal taxes, while only 19 per cent of the income of the printing industry was so taken.[119] Although during much of this period a two-year carry-over of net losses was allowed, apparently inequality still existed.

In 1937 and 1938, the American Institute of Accountants Committee on Federal Taxation advocated either a tax based on five years' average earnings or a carry-over privilege of five years. The committee felt that either plan would accomplish the following desirable goals:[120]

(1) Equalization of the tax burden.

(2) Stabilization of Federal revenue.

(3) Minimization of administrative problems.

(4) Minimization of controversies regarding the year in which an item belongs.

(5) Use of a long-range viewpoint.

There was no provision for carry-over of net losses in the 1913, 1916, and 1917 acts.[121]

In the 1918 act, Section 204(b), it was provided that:

If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears . . . that any taxpayer has sustained a net loss, the amount of such net loss, shall . . . be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and Title III for such preceding taxable year shall be redetermined accordingly. . . . If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall . . . be allowed as a deduction in computing the net income for the succeeding taxable year.

In its discussion of Section 204(b) of the 1918 act, the Senate Finance Committee said that the absence of carry-over privileges in the law up to 1918 allowed for simplicity of administration but permitted serious injustice under actual business conditions and current high tax rates.[122]

The Senate Finance Committee was in favor of allowing net losses of 1917 or 1918 to be deducted in the succeeding taxable year; and net

losses in future years to be deducted from net income of the preceding year, or if such losses were in excess of the net income for such preceding year, the excess to be deducted from income in the succeeding year.

The Section was finally confined to net losses sustained during taxable years beginning after October 31, 1918, and ending before January 1, 1920.[123]

Emphasis in this section appears to be placed on a carry-back to a preceding year rather than on a carry-forward. Apparently the idea is that the tax of the earlier year should be small enough to allow a reserve to absorb losses of the next year.

In 1924, a net loss of 1920 was held, by court decision, not chargeable against income of prior years under Section 204 of the 1918 act.[124] The year of 1920 appears as a gap in the period in which a carry-over was allowed. It was covered neither by the 1918 act nor by the 1921 act.

Perhaps, in order to simplify administration by making amended returns unnecessary, emphasis was changed from the preceding year to the succeeding year in 1921. In both the 1918 and 1921 acts, three years might be affected; in 1918—the preceding, current, and succeeding; in 1921—the current and next two succeeding.

Section 204(b) of the 1921 act stated:

> If for any taxable year, beginning after December 31, 1920, it appears . . . that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year. . . .

Section 204(b) of the 1921 law remained substantially unchanged until the 1932 act was passed. In the intervening years, a two-year carry-over of net losses to succeeding years was permitted.[125]

In 1932, an effort was made to remove the loss carry-over provision altogether, but it was retained, reduced from two to one year. The new provision had a partially retroactive effect also.

> If, for any taxable year, it appears . . . that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called "second year"); . . .[126]
>
> If for the taxable year 1930 a taxpayer sustained a net loss within the provisions of the Revenue Act of 1928, the amount of such net loss shall not be allowed as a deduction in computing net income under this title. If for the taxable year 1931 . . . , the amount of such net loss shall be allowed as a deduction in computing net income for the taxable year 1932. . . .[127]

The Senate Finance Committee opposed complete exclusion of the privilege on the grounds that it was necessary to protect against hardships inherent in a tax law based on arbitrary annual accounting periods and

that taxpaying ability does not exist if a substantial part of a year's profits are necessary to cover a prior year's losses.[128]

The House bill contained the words "after the taxable year 1933," in Section 117(b), in the first sentence, after "If, for any taxable year," but they were stricken out by the Senate Finance Committee. The limitation of the carry-over to one year and the suggestion of its complete elimination were prompted by an urgent need for revenue.[129]

The phrase in the House bill regarding 1933 is interesting in that it indicates a willingness by the House to make a change, after 1933, to the one-year plan, although the Senate forced through the one-year rule in the 1932 act. Apparently the House desired complete elimination in 1932. Be that as it may, the reduction in 1932 and the need for revenue laid the groundwork for the drastic change introduced in the National Industrial Recovery Act, passed January 16, 1933. The N.I.R.A.[130] repealed Section 117 of the 1932 Act (in addition to other sections) as of January 1, 1933. Prohibition of the carry-over privilege altogether thus occurred for the first time since its inclusion in the act of 1918.

The reason given for the elimination was the necessity for prevention of further distortion of tax liability on the part of taxpayers,[131] although this may be doubted in view of the revenue-enhancement purpose advanced in 1932.

In spite of the objections of businessmen and accountants,[132] the right of carry-over had no part in the general income tax computation of income until it was reintroduced in the revenue act of 1939.

The 1939 act does much to make the tax burden more equitable as between taxpayers with steady and those with fluctuating incomes.[133] The two-year carry-over used in the revenue acts of the 1920 decade was reintroduced by Section 122.

> The term "net operating loss carry-over" means in the case of any taxable year the sum of:
>
> (1) The amount, if any, of the net operating loss for the first preceding taxable year; and
>
> (2) The amount of the net operating loss, if any, for the second preceding taxable year reduced by the excess, if any, of the net income (computed with the exceptions and limitations provided in subsection (d) . . .) for the first preceding taxable year over the net operating loss for the third preceding taxable year.[134]
>
> As used in this section, the terms "third preceding taxable year," "second preceding taxable year," and "first preceding taxable year" do not include any taxable year beginning prior to January 1, 1939.[135-6]

This reform has been received with skepticism, however. The carry-over privilege was included in our system during the relatively prosperous 1920's; but when corporations began to operate at a loss, the privilege was limited in 1932 and withdrawn completely in 1933. Perhaps, history

may repeat itself and the carry-over provision may again be withdrawn when business becomes unprofitable and Government revenues scarce.[137]

Limitation of Losses

THE NET LOSSES permitted by the acts of the various years to be carried over to preceding or succeeding taxable years have always been limited amounts and have not been the same figure as shown on the tax return for the year of the net loss.

The first limitation appeared in the 1918 act, since no carry-over provision was included in the 1913, 1916, and 1917 laws. Section 204(a) of 1918 stated:

> That as used in this section the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired . . . on or after April 6, 1917, for . . . the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations an amount allowed as a deduction under paragraph (6) of subdivision (a) of section 234)[138] over the sum of the gross income plus any interest received free from taxation both under this title and under Title III.[139]

The early intent clearly was to allow a carry-over only of net operating losses; all other items were excluded, with the exception of losses arising out of facilities devoted to aiding the Government in the War.

This section was expanded sufficiently in 1921 to justify a complete quotation of Sec. 204(a) of the 1921 act.

> That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234,[140] as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost.

Again, the major limitation is that the losses be suffered in trade or business. Unlike the 1918 law, the 1921 act permitted losses on long-lived assets used in the business to be treated as operating losses; the 1918 act permitted such to be carried over only if incurred on assets

acquired after a certain date and for the express purpose of furthering the prosecution of the War. This provision of the 1921 act, therefore, represents a decided improvement over the previous act.

The net loss for carrying-over must be reduced by the excess of tax-free interest received over non-deductible interest paid to acquire or hold such tax-free interest bearing securities. A further reduction must be made for net deductible losses not sustained in such business (the excess over taxable gains derived from such sources).

Dividends received and allowed as deductions and the excess of depletion based on discovery value deducted over depletion based on cost must both act as a reduction on the loss carry-over allowed.

In short, in determining net loss for carry-over purposes, the income tax ignores its own provisions for determining net taxable income. It sets up certain adjustments designed to get at the real net loss of the taxpayer. Most of the things it adjusts for (tax-free interest, dividend credits, and depletion adjustments due to discovery value) should be adjusted for in its regular computation of income also. They represent items which are handled differently for usual tax purposes from the treatment given them in accounting calculations of income. The net loss carry-over is thus more logical than are the provisions for determining taxable net income. The limitation on net losses over net gains derived from non-operating sources is not defensible, however.[141] A carry-over provision, to be helpful and to recognize the long-range and over-all character of income, should allow the carrying over of all net losses.

The artificial nature of depletion based on discovery value is definitely recognized in this section. Such recognition should be extended to other sections of the law as well.[142]

The provisions of Section 204(a) of the 1921 act remained in force substantially unchanged throughout the entire period of 1921-1932.[143] In 1928 and 1932, the provision regarding discovery value depletion was expanded to include percentage depletion also.[144]

When the carry-over provision was re-introduced in 1938, the limitation on "net loss" was also restored in part. Section 26(c) (2) of 1938 states:

> As used in this title the term "net operating loss" means the excess of the deductions allowed by this title over the gross income, with the following exceptions and limitations—
>
> (A) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under Section 114(b) (2), (3), or (4);
>
> (B) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this title, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax exempt obligations.

The limitation provision has again been changed and expanded in the 1939 act.

As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions and limitations provided in subsection (d).[145]

The amount of the net operating loss deduction shall be the amount of the net operating loss carry-over reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction);[146]

The exceptions and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114(b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23(b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deductions shall be allowed;

(4) Long-term capital gains and long-term capital losses shall be taken into account without regard to the provisions of section 117(b). As so computed the amount deductible on account of long-term capital losses shall not exceed the amount includible on account of the long-term capital gains, and the amount deductible on account of short-term capital losses shall not exceed the amount includible on account of the short-term capital gains;[147-8]

Carry-Over of Net Loss

Regarding Section 206(b) of the 1924 act, the Senate Finance Committee made it clear that the amount of net loss shall be deducted in computing net income for the succeeding years but not in computing net loss of the succeeding years.[149] To allow the latter would be equivalent to permitting net losses to be carried indefinitely until they were wiped out.[150]

The intent that net losses should not be carried forward to create net losses was made quite clear in section 117(a) (6) of the 1928 act:[151]

In computing the net loss for any taxable year a net loss for a prior year shall not be allowed as a deduction.

This attitude was upheld by court decision.[152]

Length of Arbitrary Income Determination Period

When periodicity is introduced into the income calculation, a decision must be made regarding the sort of arbitrary period to be used. It has been customary to use the year as the measure of time, because the year denotes a natural cycle for many things. A question may be raised, how-

ever, as to whether or not the use of approximately three hundred and sixty-five days is natural for business affairs. Some business concerns already have deviated from the use of twelve months and have altered their accounting year to include thirteen approximately equal periods, but they have still remained within the same total number of days.

Perhaps, instead of using one year as the income determination period, some device should be used for calculating income for a number of years encompassed within a complete business cycle. Tentative tax returns and payments could be made, subject to revision as the years of the cycle unfold, and tentative tax rates could also be used subject to later revision as conditions require. The important thing is that a complete economic cycle could be used as the basis for income determination, especially for tax purposes. The question might be raised as to the duration of the cycle to be used. Historical information might be the basis for advance determination of the duration of the cycle, or it might be left unforecast and subject to later determination as events reveal themselves. It is not by any means suggested that the delimitation of the cycle would be an easy matter, but it is merely offered as a possible way out of our difficulties.

Fiscal or Calendar Year

EVEN IF the alternatives to a year as the income calculation period are dismissed, there is still the problem of choosing the beginning and end of the year to be used. Inertia has caused the calendar year to be chosen in most cases, but it is encouraging to note the increasing use of the natural business fiscal year instead of the calendar year.[153]

The Federal income tax law recognized early and has since allowed the use of a fiscal year other than the calendar year by the taxpayer.[154] For convenience, of course, it has been required that the tax year must end on the last day of some month.[155] Perhaps, since in some cases this provision has caused a slight deviation from the use of a natural fiscal year by the taxpayer, it might not be placing too heavy an administrative burden on the Bureau to allow fiscal periods to end in the middle of a month.

The attitude of the Treasury Department has been stated in the Regulations[156] thus:

> The Federal income-tax law authorizes corporations, . . . under certain conditions, to make their returns on the basis of an established "fiscal year" or consecutive 12-months period, which may be other than the calendar year.

The use of a natural business year already points in the direction of a more judicious selection of the period for determining income.[157] It is, in a sense, a short-term business cycle. Perhaps, this is the opening through which may be driven the use of a full, long-life economic cycle for the determination of income.

Summary of Chapter

FUNDAMENTALLY, income is a long-range concept, but since individual business enterprises have assumed longer periods of life, it is inexpedient to await the termination of the life of the business enterprise before measuring income. Periodicity, the use of short arbitrary periods, has come into vogue, bringing with it the major problem of accounting—matching.

The matching of asset inflows and outflows encompasses the following problems:

(1) Differentiation between capital and revenue expenditures.[158]
(2) Amortization of long-lived assets.[159]
(3) Accruals and deferments.
(4) Reserves.
(5) Classification of recurring and non-recurring inflows and outflows.[160]
(6) Determination of the emergence or realization of gross income.[161]
(7) Use of carry-over and average income schemes for taxation purposes.

This matching procedure has long been recognized in accounting and the income tax, but there has been some disagreement as to the implications of matching and the methods for putting it into operation.

In accounting, the plan generally has been to determine gross income on its emergence and to relate with it any asset outflows (expenses or costs) which can be said to be related. In addition to such matching deductions, certain additional outflows (losses) unrelated to any inflows must be deducted from the net inflows already determined.

There has been steady improvement in the income tax concept of accrual since 1909, when, although the act was not so enforced, a cash basis was the sole method approved by statute. The 1913 act was designed to include accrual accounting, and so were all of its successors.

The Bureau has allowed deviations from strict periodicity only where it is necessary to reflect income correctly and in cases of overlapping items which offset each other and have been consistently treated.

Limited relief from disallowances of deductions and changes in the point at which income is said to have emerged has been provided by the use of amended returns. Such relief is only partial, because a statute of limitations has been set up in regard to amended returns.[162]

Recognition of accrual under the income tax is slower than under accounting methods. The law has placed great emphasis on the existence of a valid claim enforceable by law. Emphasis is on the determination of whether or not the income or expense has become due, rather than upon the matching procedure.

From about 1915 to 1925, the statutes and decisions regarding the income tax have held the idea of *coming due*. In 1926, the Supreme

Court handed down three decisions which recognized the broad matching concept of accrual. Since that time, the general trend has been toward the accounting view of accruals, although some few scattered decisions have been made to the opposite effect. The Bureau of Internal Revenue still maintains its old attitude, however; it was reversed twice in 1939 by the Board of Tax Appeals on this matter.

Certain plans for leveling out the peaks and valleys of income acquisition have been incorporated in our income tax system for most of the years of its existence. The first carry-over of net loss was for two years and was introduced in the 1918 act and applied to 1918 and 1919. There was no such provision in 1920, but one was reintroduced in the 1921 act. From the 1921 law to and including the 1928 act, a two-year carry-over was permitted. In 1932, the carry-over was limited to one year; in 1933 it was removed entirely. It was reinstated in modified form in 1938 and has been continued in 1939; in the earlier year it was a one-year carry-over; in 1939, a two-year carry-over.

The loss to be carried over has always been a limited amount and not the loss as shown on the tax return. In 1918 it was restricted to operating losses and fixed asset losses associated with the furthering of the war. All fixed asset losses connected with the business were allowed in 1921. Limitations on capital losses or fixed asset losses have appeared in all of the laws in which carry-over provisions have been included.

In the 1921 and succeeding acts, (1) net tax-free interest income is included in income for the purpose of determining net loss for carry-over, and (2) only depletion based on cost may be included in the loss figure. Both of these adjustments are satisfactory and might well be extended to the ordinary computation of taxable net income.

The calendar year usually has been selected for both tax and accounting use, although accountants have advocated and the income tax has always permitted a fiscal year.

In certain respects the trend of the income tax has been good.

(1) Since 1926, the nature of accruals has become better recognized. More relief should be furnished for corrections of returns of prior periods, however.

(2) Carry-over losses have been allowed up to 1933 and have been resumed in 1938 and 1939. Whether or not a two-year carry-over is adequate is open to debate. Some of the limitations to the loss to be carried forward are excellent and should be applied to the general determination of income. Others, dealing with capital gains and other extraordinary gains, should be modified or removed. Except for its reinstatement after an absence of several years, there has been no real improvement in this provision.

(3) Slightly increased use, with the sanction of the Revenue Department, has been made of fiscal years for income calculation.

CHAPTER IV

INCOME REALIZATION

THE BROAD CONCEPT OF INCOME is *net increase in purchasing power gained from the time of the inception of an enterprise to the time of its dissolution* (exclusive of additional investments and withdrawals). Realization[1] is not important in this conception, because measurement is made after dissolution. Arbitrary, short-term income calculation periods cause realization to assume an important position in the determination of income.

> It is a common assumption that profits exist only when the increment in wealth is realized. In this opinion there is rather unusual agreement of many accountants, jurists, and economists.[2]

Essentially, realization is necessary for a usable determination of income, in that it marks a convenient place at which objective and fairly accurate measurement of income may take place. Income might exist other than at the time of realization, but for practical purposes, it is not measurable and is not recognized.[3]

> . . . there is a widespread agreement that the accountant is concerned primarily with realized profits, unfortunately there is failure to agree as to when profits are realized or as to the circumstances or conditions which constitute realization.[4]

The tax rules for realization or recognition of income for measurement are built around the requirement of objectivity, convenience, and ability to pay. Subjective conceptions have no place in a good tax system: most accountants feel that unverifiable opinions, likewise, should have no position in accounting calculations of income.[5] Emphasis on objectivity forces the abandonment of recognition of certain items which have a place only in theoretical concepts of income.

Practically, unmeasurable unrealized appreciations and decrements in asset prices must be eliminated from income.[6] Revaluations, unaccompanied by exchange or loss transactions, have been omitted quite generally from tax and accounting calculations of income,[7] but an apparent inconsistency has been allowed to enter into the determination of income by means of downward revaluations of current assets.[8]

Recognition of devaluations of current items is founded on the belief that such changes are more measurable and certain than are changes in fixed asset prices. Inconsistency arises when price changes upward and changes related to long-lived assets are omitted even though they may be fairly objective and measurable. If objectivity and measurability are the criteria for income recognition, they should be used consistently.

Opinions as to the time for recognizing income vary from those based on unrealized appreciation to those based on a satisfaction-received basis. The former recognizes income earlier and the latter, later, than the usual closed-transaction rules generally followed in accounting and tax computations of income.

Each of the several possible times for recognizing income, and the related accounting and income tax provisions, are considered in the remaining pages of this chapter in the order in which they grant recognition to the existence of income.

Accrual Basis—General

For corporation income reporting, the accrual basis is given the most widespread approval by both accountants and the Federal income tax.

As early as 1918[9] the Regulations provided for the accrual basis for income:

> Gains, profits, and income are to be included in the gross income for the taxable year in which they are received . . . , unless they are included when they accrue . . . in accordance with the approved method of accounting followed by (the taxpayer). . . .

This provision was followed in 1921 and 1924.[10] In the 1926 and subsequent Regulations the rule has been substantially the same except for a change in wording.[11]

Under the 1913 act, income accrued but not received was not taxable to corporations.[12] However, the accrual basis was added to the law in 1916.[13] In subsequent years, the Board of Tax Appeals has upheld the validity of the accrual basis.[14]

Whenever the cash basis does not indicate the true circumstances, a tax return on the accrual basis must be filed.[15]

Because of measurement difficulties in some cases, however, full accrual income determination is not used. Even in some cases in which accruals might be computed, they are ignored and a form of objective event rule is substituted.[16]

Bond discounts and premiums, interest, and amortization of assets[17] are generally considered to accrue and are given recognition before the occurrence of some objective event.

> The denial that profit can exist without a sale and the simultaneous recognition of accruing interest as profit is another of the many inconsistencies in accounting practice.[18]

Such items are accrued if they are considered sufficiently measurable and collectible. However, doubtful measurability or collectibility are sufficient reasons for non-recognition of the accrual of items.

The Bureau of Internal Revenue has been criticized on the score that it has insisted that mortgage-holders on an accrual basis should accrue

interest as income even when the interest has been in default for some time.[19] An early ruling held that interest accrued and entered on the books is taxable even though of doubtful collectibility.[20] Emphasis was thus placed on the legal existence of a right of collection; in such cases a deduction was permitted for items when they were proved uncollectible.

The Board of Tax Appeals agrees with one critic who made the statement that:

> The propriety of the application of the principle of accrual accounting is abrogated unless there is reasonable expectancy of current realization.[21]

In many cases, the Board and the courts have held that where books are on the accrual basis, there is no requirement that income which may never be received shall be accrued.[22]

A taxpayer may not exclude from income an item merely on the ground that it may have to be repaid in a subsequent year if certain conditions materialize. The unrestricted right to the use of money in the interim is considered the important characteristic.[23]

Under the Regulations of 1913, there was some confusion as to the taxability of unrealized appreciations. At least one Article[24] apparently sanctioned the taxation of such items, but was reversed by a later treasury decision.[25]

The Regulations in more recent years have ruled out mere appreciation as a subject for taxation:

> . . . appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property.[26]

Both the courts and the Board of Tax Appeals have supported this rule.[27]

If objectivity is to be the basis for accruing income, it is difficult to understand why changes in prices of assets should not be made when independent and objective market quotations are available. Such quotations are frequently more truly objective than are prices set in certain sale or exchange transactions. The only thing such quotations lack is reliance upon them in a transaction consummated by the enterprise for which income is being computed.

A frequent objection advanced against using such quotations is that the market price may drop and wipe out the gain. This objection is valid but applies equally well in many cases of completed transactions. The proceeds from such transactions might be reinvested in other property which also might drop in price, or the money received might be of less value following a subsequent increase in the general price level.

Accrual Basis—Performance of Function

A FORM OF accrual computation and a deviation from the general sale rule for taking up income is given the support of accountants and the

income tax law in the case of certain special types of sale transactions. This method of calculation recognizes income before a sale is made.

Frequently income is recognized at the time production is completed or as production progresses and before any sale has been completed. This exception to the general rule is tolerated when the sale is assured and is considered only an additional step in the productive process. Cost-plus contracts, long-term contracts, production to order arrangements, and production of natural resource products with assured buyers (farm-price method) are considered eligible for such special treatment.

Natural increases due to growth are also often given recognition as realization of income. Examples of such increases are found in any industry whose product undergoes aging, in cattle-raising, in orchard operations, and so forth.

Closed Transactions—General

THE closed transaction rule is not invariably applied in accounting, witness the use of accruals.

> . . . There are two main tests applied in determining when charges or credits to income account arise—one is the accrual test, and the other is the test of completion of a series of transactions. We say that a charge or credit to income arises when a series of transactions is completed—not because the gain or loss is, in fact, attributable to that one moment of time, but because the rule, though conventional, has worked well in practice.[28]

It is peculiar that although so very much emphasis is placed by accountants on the closed transaction, they criticize adversely the income tax (becoming due) concept of accrual.[29]

Both accounting and tax computations use the closed transaction as an attempt to get at money's worth[30] or income in terms of cash; both are ability to pay conceptions of income; emphasis is on the subjection of the net increase in assets to the recipients' "separate use, benefit, or disposal." The general requirement that an adjusted cost basis for assets be used in income determination is another manifestation of the stress placed on the closed transaction for calculating income.

When is a transaction closed and completed? The usual rule is that an objective event marks the end of one transaction and the start of another. Just what the event should be is difficult to determine. The usual choice is the sale transaction. The sale event as the end of a transaction is subject to many exceptions in which income is recognized either before or after the sale.

Ordinarily, in order that a transaction shall be considered objective, it must be a completed transaction with an outsider, as distinguished from the corporation's dealings with itself or its stockholders. It is not absolutely necessary that every detail of a transaction be completed in order

that the transaction be considered closed for income tax purposes.[31]

There is no invariable rule for determining the end of a transaction, and, for that reason, the closed and completed transaction basis for recognizing income is open to the objections voiced against any other rule based on a shifting foundation.

In some cases, income might well be deferred past the point of objective realization because of certain related expenditures which remain to be made. Whether the income is deferred or the expenditure accrued is of little moment. The important thing is that net profit of the present period is reduced.

Cases involving future maintenance by contractors are illustrative of this problem. It has been held that amounts withheld by the vendee to guarantee maintenance are not income at the time the job is completed.[32] The Board has said that:

> . . . a taxpayer on the accrual basis is not required to include in income sums to be received in the future where there is a substantial contingency as to the amount to be received or the time of its receipt, . . .[33]

In other similar cases, such amounts were not withheld and the full amount of the contract was taxed, although a maintenance guaranty was required.[34] Emphasis was thus placed on the fact that in this latter case amounts were received unrestricted as to use.

Closed Transactions—Sales and Exchanges

A CLOSED transaction between unrelated parties dealing at arms-length is considered by most accountants and the income tax provisions as being capable of furnishing the most objective evidence of income. Many assumptions are tied up in this closed and completed transaction concept which are often missing from actual transactions. A free exchange between fully competent and cognizant traders in arms-length dealings is frequently not the actual case. The income tax law has banned, therefore, some colorable transactions, even though it grants recognition to the completed transaction basis in general.

The advantages of the sale as a test of income realization may be said to be that it is accurate in most cases, uses a regularly recurring business transaction, is simple in operation, is fairly uniform in application, can be varied in unusual cases, indicates what has or shortly will become cash, and has a preferred legal standing (evidence of a completed transaction).[35]

That a sale is not complete evidence of the existence of income has been recognized in the case of sales the proceeds from which are of doubtful collectibility[36] and in the proposals frequently made that some sort of averaging procedure should be used for income determination.[37]

Provisions for doubtful accounts are also a recognition that the sale itself is not absolute proof of income but only a safe and convenient point for measurement in most cases. Reserves for future maintenance[38] also weaken the idea that sales are always final evidence of income.

Even the application of the sale rule is not simple, since there is no great amount of certainty and uniformity in its application, as can be seen from the examples to be enumerated below.

Goods sold and invoiced but held by the manufacturer are not to be considered in income unless they can be identified specifically and are in deliverable condition.[39] Where, under state law, no title (legal or equitable) passes to the purchaser under conditional sales contracts, there is no sale in the year of the contract from which taxable income is derived.[40] However, it has been decided that title passes where the parties intend; legal rules do not govern if the intention is otherwise.[41]

A sale may be a closed transaction even though the purchase price may not have been determined definitely.[42] There is no uniform agreement as to the role the passage of title should have in the sale transaction for income determination purposes. Some people feel that title should pass before profit is recognized, but this appears to be too extreme.[43]

> It is nevertheless true that accounting practice has not been very meticulous in its observation of the matter of passing title but has more generally specialized on the fact of shipment as the indication that the sale transaction is complete, though in certain types of sales contracts title undoubtedly passes at some earlier point.[44]
>
> Probably with the wide diversity in methods of retaining or passing title in installment sales agreements title has become of less accounting significance.[45]

The Board of Tax Appeals has decided that a sales transaction is closed when the sales contract definitely fixes the liability of the parties and nothing remains for either party to perform to make the transaction a binding one.[46] A similar rule has been worked out by the court and has been the subject of adverse criticism by accountants.[47] The court said:

> If a taxpayer receives earnings under a claim of right, and without restriction as to its disposition, he has received income which he is required to return even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[48]

Where property is acquired as a whole for a lump sum, and parts are sold, profit is to be computed on the parts sold; one need not wait until the entire cost is recovered.[49]

Closed Transactions—Sales and Exchanges—Exceptions

In some cases it is considered satisfactory, even preferable, to delay recognition of income beyond the point of the sale itself.

. . . profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that collection of the sale price is not reasonably assured.[50]

When the term of collection is long delayed and reasonable estimates of probable uncollectibility and expenses cannot be made, the sale may be regarded as not providing objective and accurate means of income measurement. Installment sales are examples of transactions which are considered worthy of special treatment.

According to the Regulations, deferred payment sales of real estate fall into two general classes: installment sales and deferred payment sales not on the installment plan.[51] Installment sales are characterized by a small down-payment and numerous small future payments.

The Regulations of 1934, 1936, and 1938 stated that if the entire purchase price is to be paid in a lump sum in a later year, there being no payment during the first year, the income may not be returned on the installment basis. Income may not be returned on the installment basis where no payment in cash or property, other than evidences of indebtedness of the purchaser, is received during the first year, the purchaser having promised to make two or more payments in later years.

Deferred Payment Sales of Real Estate Not on the Installment Plan

SUCH SALES of real estate, not on the installment plan are more certain of collection than are those in which only a small down payment is made and most of the balance is deferred far into the future. The obligations received from the purchaser for deferred payments are, therefore, to be regarded as the equivalent of cash. The profit indicated by the total consideration is taxable income for the year of the initial payments and the assumption of the obligations.[52] The ordinary sales rule is thus in effect.[53] In the 1921 and subsequent Regulations, the obligations received are to be considered the equivalent of cash only if they have a readily realizable market value.

Installment Sales of Real Estate and Personal Property

THE TAX method for computing installment sales income is the accepted accounting method of basing income on a percentage of collections.[54]

A person who regularly disposes of personal property on the installment plan may return as income in the year of payment that proportion of installment payments actually received in that year which the total profit realized or to be realized when payment is completed bears to the total contract price.[55] Similar regulations antedated the law and have

appeared since 1916.[56] Recognition was given the installment method in the acts of earlier years too, but the method of computation was not outlined.[57]

In order that casual sales of personal property may qualify under the installment sales method they must exceed $1,000.00. In addition, such sales and sales of real estate may qualify under the installment plan for returning income if they have involved only a limited initial payment. The initial payment is held to include not only the down payment but also all other payments made in the year of sale.[58] A twenty-five per cent limitation was made in the acts up to that of 1928. Forty per cent was specified under the acts of 1928 and 1932. The limit was reduced to thirty per cent under the more recent statutes.

The twenty-five per cent limit was raised in order to extend the privilege of the installment sales method to many more sales with no assured collections.[59] But it was dropped later to thirty per cent from forty per cent because the Ways and Means Committee felt that in many cases recognition of income was being delayed unduly.[60]

Treasury Decision 2090, December 14, 1914, held that profits were to be taken when the sale was made. The Regulations of 1916-1917[61] relaxed the provisions. They permitted the percentage of collection method to be used in cases where the vender retained title; where title passed, the ordinary sale method was still required. In the Regulations of subsequent years and in several Board decisions, it was decided that income on installment sales could be reported on the installment basis regardless of whether or not title has passed.[62]

For a number of years, the installment method had been given general recognition under the law and specific recognition and discussion in the Regulations; but in about the year 1925, several Board decisions were issued to the effect that such Regulations were invalid under the 1924 and prior acts.[63] In order to validate the Regulations of prior years, Section 1208 of the 1926 act was made retroactive to the acts of all of the years as far back as that of 1916.

The Regulations require that deductions must be taken in the year when the expenditure is paid, incurred, or accrued, and must not be allocated as is the gross income.[64] This rule has been upheld in several decisions.[65] However, in several recent Board decisions, it was held that when real estate is sold on the installment plan, the selling expenses should be spread over the period of the installment payments and not deducted in full in the year of sale.[66]

The reserve method for bad debts is not available in the case of installment sales. The amount to be deducted is the unrecovered cost if the property is not recovered on default; the deduction should be taken when the default occurs.[67]

Long-term Contracts

RECOGNITION has been granted under the Federal income tax that special treatment may well be accorded the income from long-term contracts. The Regulations define long-term contracts as those which are not completed within a year. Special provisions are restricted to long-term building, installation, and construction contracts; other types are not included.

> In cases wherein contracts are fully performed in one year, although payment therefore may be deferred until the next, the income resulting from the performance of the contract shall be returned for the year in which it was actually earned and determined.[68]

The Regulations have permitted two special bases for recognizing income; the completed contract and the percentage of completion bases.[69]

The completed contract basis requires that all amounts received on a completed contract be returned as income in the year of completion; all amounts expended on the contract are deductible at the time of completion in order to arrive at the net income on the contract completed.

The alternate basis, the percentage of completion method, permits the taxpayer to include in gross income that proportion of the total contract price which the costs and expenses incurred bear to the total estimated costs and expenses. All expenses and costs incurred in the taxable year are deductible from the estimated income thus computed.

The percentage of completion method has won some favor among accountants, although they indicate that it is a departure from the general sale rule of computing income. Adequate reserves and due conservatism are recommended by those who are willing to permit the use of this method.[70] Cost-plus contracts are similar to other long-term contracts; except for the bankruptcy or other inability of the vendee to pay, there is no probable loss to be incurred on such contracts, and conservative reserves are not advocated.

Even prior to the Regulations of 1916, the Treasury Department accepted the cash accounting basis as well as the accrual method for determining income from long-term contracts.[71]

The Board of Tax Appeals has supported the use of both the completed contract[72] and percentage of completion[73] bases and has advocated the same rules for computation as were included in the Regulations. Income on long term contracts should be reported at the time of completion rather than at the end of a guaranty period.[74]

Other examples of delayed recognition are short sales, in which completion of a transaction is dependent on a subsequent purchase; C.O.D. sales;[75] and approval sales, in which acceptance determines the point at which to measure income.[76]

Cash Basis

NEITHER accountants nor Federal income tax rules favor the cash basis for income determination by corporations.[77]

> . . . in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method.[78]

A modified cash basis is considered satisfactory, however, in the case of sales with long-delayed and uncertain collections. Installment and long-term contract sales are examples.[79]

An extension of the cash collection method is found in the return of capital basis of computing income. This basis can be applied in two ways other than on the installment plan. One is to consider the first collections as profits until the balance receivable equals cost. This method is considered too risky and contrary to fact. The other application of this basis is to regard the first collections as returns of capital and the balance as income. There is some advocacy of this third method when collections are extremely uncertain.[80]

Neither the law nor the Regulations require income to be in the form of cash.[81]

> It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money.[82]
>
> The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.[83]

These rules are as they should be. Income determination should not be placed on a mere cash basis, but must be stated in terms of money for practical exposition.[84] "The only economically significant goods are those which are susceptible of evaluation in terms of money."[85]

Satisfaction Basis

REAL economic income is measured by satisfactions. Awaiting the receipt of satisfaction for the recognition of income is required neither by accountants nor by the Federal income tax. A tax on satisfactions is more closely approximated by a sales tax than by an income tax.

Dissolution Basis

INCOME can be measured accurately only when the business is dissolved and its beginning purchasing power is compared with its ending purchasing power. Under present day conditions and the use of arbitrary, short-term income periods, the dissolution basis is important only from a theoretical point of view.

Completed voyage or venture accounting represent the nearest present day approaches to income calculation on a liquidation or dissolution basis. Even the former is now almost obsolete.

Chapter Summary

THE RULES for recognizing income as realized are quite similar in accounting and under the Federal income tax law. The emphasis is on objectivity; perhaps, more emphasis is placed on objectivity for tax purposes than is true in accounting calculations of income.

The accrual basis has been recognized widely by accountants since before the advent of the income tax; the latter has contained definite recognition since 1916. Deviations, however, are made both in accounting and tax calculations in order to avoid measurement difficulties and in order to promote more objective determinations of income. Items of doubtful collectibility need not be accrued.

The accrual basis is denied in the case of so-called unrealized appreciations of assets. This has been true of accounting and of the Federal income tax since about 1914. The accrual basis is recognized under about the same conditions and in about the same manner in tax and accounting calculations for income from long-term contracts, cost-plus contracts, production to order arrangements, and farm-price situations.

Most reliance is placed upon the use of closed transactions for recognizing income. Exceptions are made for cases in which future maintenance must be furnished or in which collections are very doubtful.

The sale or an equivalent event are usually chosen as the point for recognizing income. The sale is quite satisfactory in practice because of its relatively great objectivity and simplicity. That the sale is not complete assurance of the end of a transaction or the existence of income is evidenced in the problems presented by the following things: bad debts, maintenance agreements, average income proposals, short sales, long-term contracts, installment sales, C.O.D. sales, and approval sales. In general, the tax treatment of these special problems is similar to that given under accounting rules and procedures. In neither case has legal title been considered of very great importance.

The cash basis has been quite generally disregarded by tax authorities and accountants in computing corporation income. Exceptions have been noted above in connection with special types of sales transactions.

The receipt of satisfaction and ultimate dissolution of the business enterprise have been given no important recognition for tax or practical accounting purposes.

The chaotic condition of the subject of accounting and tax determination of income is probably due to the combined and inconsistent bases used for recognizing income. There is widespread agreement that the

accrual basis should be applied to the theoretical computation of income, but, because of the practical difficulties and subjective distortions which would result from the universal application of the accrual method, a form of closed and completed transaction test has come into general use alongside of a partial accrual basis.

A correct calculation on the accrual basis requires a forecast of future events. Such forecasts are impractical and often impossible. Accounting and tax calculations require objective and measurable amounts. The result is that only certain things which are easy of measurement are accrued, and, in some cases, not even all measurable and verifiable things are accrued.

If objectivity is to be the test for recognizing income, any test which assures objective measurement should be satisfactory. No single method for considering income realized is workable without confusion in practice.

CHAPTER V

NON-RECURRING ITEMS

Recurring or Non-Recurring Items

PERHAPS THE CHIEF PURPOSE of business activity is to obtain increased control over purchasing power. Basically, all increases in purchasing power are alike in nature. The use of periodic income calculations has stressed operating income instead of total income and has caused income items[1] to be classified as recurring and non-recurring types. Further modification has been required because of the inability of accountants and others to measure certain so-called unrealized changes in purchasing power.

There appears to be more sentiment among accountants and others in favor of including all additions to and deductions from gross income in determining net income[2] than in support of the exclusion of extraordinary gains and losses.[3] Those favoring such inclusion generally restrict it to realized items.

> The more one seeks for distinctions between abnormal losses and normal losses (assuming there is such a thing as normal losses), the more the question arises whether there is in fact any principle underlying such a distinction.[4]
>
> Since it would appear that business and financial losses, both normal and abnormal, arise from the same basic factors, it follows that abnormal losses are to be designated as such largely because of their being of unusual amount, and that this in turn is due to unusual and diverse activity of forces which are operating more or less at all times, both good and bad. Should not, therefore, the losses occurring in any given period be charged to the income accounts of that period? This is generally recognized as the proper practice in the disposal of losses on working assets. . . .[5]

Some persons draw the line between inclusion and exclusion on the basis of the control management has over the loss or gain. Those items clearly beyond the control of management (such as "Acts of God") are excluded from the income calculation.[6]

Periodicity has caused confusion to creep into the matter of so-called operating expenses and losses as contrasted with extraordinary or capital losses. There is no essential difference between them, except in the matter of frequency and predictability. In both cases, losses arise when (1) inflows are not sufficient to cover outflows of assets, and (2) there are no inflows to match, even partially, the outflows.

Even though we may blame the use of periodicity for the rise of artificial classes such as capital assets, capital gains, and capital losses; such unessential groupings are not necessary even when periodicity is

used. All that is needed is to recognize that some gains and losses are less predictable and occur less frequently and regularly than others.

Asset outflows take the form of expenses, expense-losses, predictable extraordinary losses, and unpredictable extraordinary losses.[7] Assets which have expired and have been covered by gross income are expenses; those which have expired and have not been entirely covered by gross income are expense-losses. Both expenses and expense-losses are recurring and purposive in nature and are comparatively easy of allocation to proper income calculation periods.

Asset expirations of an extraordinary nature are those which usually have occurred without direct intent of encouraging gross income asset inflows and are usually fortuitous in nature.

Even if substantial agreement were to be reached that inclusion of all gains and losses in income is necessary, there would still remain the problem of allocating extraordinary gains and losses to proper income periods.

Experience and adequate records make possible sufficiently accurate estimates of the probable amount of many losses and the sum to be allocated to particular income periods over the entire holding period of the asset disposed of.

Other extraordinary losses are quite unpredictable and cannot be foretold or spread among several accounting periods accurately.[8]

Flood, storm, and other catastrophic losses, and losses on the sale or other disposition of non-inventory assets are usually unpredictable and beyond the scope of matching by means of accrual accounting. However, obsolescence, fire losses, inadequacy losses, abandonment losses, and similar items frequently are sufficiently measurable and subject to forecast to be the basis for periodic deductions in arriving at net income. In other cases, however, they too are sufficiently unpredictable and immeasurable to require exclusion from *spreading*.

Provisions for doubtful accounts receivable, for self-insurance, and similar items are often considered forms of operating expense deductions.[9] Perhaps instead they should be classified as current period allocations of predictable losses which are expected to occur in the future.

The various asset outflows differ principally in that the amount of predictability varies and makes measurement and provision impossible or too inaccurate for satisfactory use.

When do extraordinary losses occur? Do they accrue gradually over the period the asset is held? Or do they arise all at once when some event occurs?

These questions must be answered before proper treatment of extraordinary losses can be prescribed for income calculation purposes. If it is decided that losses occur at a given moment rather than over a period

of time, perhaps it is necessary to exclude all accruals of predictable extraordinary losses. Such exclusion might necessitate the removal of provisions for normal obsolescence, self-insurance, bad debts, etc., from the income calculation.

However, it may be objected that bad debt losses are in existence from the very moment the non-cash sale is made and that, therefore, a reserve based on charge sales is proper, even though the ascertainment of the actual amount of loss is delayed to a later date. In the case of deductions for accumulated normal obsolescence, a similar argument might be used to the effect that the loss accrues over the period the asset is held and is inherent in the very acquistion of the asset.

A similar line of reasoning may be used to justify the accrual (only on a theoretical basis in some cases, perhaps) of any loss over the period the asset associated with the loss was held.

In short, this line of reasoning denies the separate existence of losses other than expense-losses. All asset expirations are either expenses or expense-losses. Emphasis is thus placed on the spreading of asset price over the periods during which the asset was held rather than on the loss feature.

The objective closed transaction point of realization of a loss may then be regarded as necessary only for unpredictable extraordinary losses; necessary only for practicable measurement of asset expiration, but not necessary from a theoretical point of view.

A current spreading of all but unpredictable losses is possible for accounting and tax calculations of income, but what shall be done with those losses which occur without having been forecast?

One solution might be, of course, to prepare amended income statements.[10] Perhaps this course is best, but it is impracticable.

Another possible answer might be to treat such losses as deferred items to be spread over a certain number of future periods. The result would be incorrect income figures not only for periods prior to the discovery of the loss, but also for future income periods.[11] However, the deferring of such losses has much to recommend it for tax purposes from a viewpoint of equity under any system of graduated tax rates. A specially designed profit and loss statement has been suggested in which would be included corrections of errors of past periods as well as current period items.[12]

Much of what has been said of predictable and unpredictable extraordinary losses applies equally well to extraordinary revenues.

Losses on the disposition of assets are usually not amenable to periodic measurement and are, therefore, not deducted in periodic income calculations.[13] Gains on the disposition of assets are very similar to losses on the disposal of assets in that they are uncertain. They are excluded from

periodic income calculation, just as were the losses, not because they are not a proper part of its determination, but because no satisfactory methodology has been devised to make their inclusion feasible.

The spreading of extraordinary gains may be objected to on the ground that no separation of income has taken place which would furnish the business enterprise with additional assets available for use.[14] However, the existence of income is a fact; whether or not it is in a form available for immediate use is a different matter.

The method followed by most accountants and used for Federal income tax purposes is to take up unpredictable losses, and gains too, in the period in which they are discovered.

Approval can be given to this expedient solution because of the inability to measure such items satisfactorily. It is this type of treatment which has caused the principal objections and problems associated with tax treatment of capital gains and losses and other losses and gains of a similar nature.

Some form of average taxation[15] might be adequate to remove most of the inequities resulting from taking such losses and gains into consideration all at once when they are discovered.

Under the income tax regulations, the entire amount of gain or loss on the sale or exchange of property is recognized, subject to specifically enumerated exceptions only.[16]

> In general, the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the cost or other basis . . . , and the loss is the excess of such . . . basis over the amount realized. . . .[17]
>
> The amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received.[18]

The above provisions of the 1924 Regulations were continued in substantially the same fashion in all succeeding years.[19]

The Federal income tax is extremely broad in nature, and, in general, attempts to levy a tax based on a broad concept of income, modified for certain expedient reasons related to measurement and policy.

> The United States Supreme Court has said of the revenue acts that they reveal in their provisions an intention to reach "pretty much every sort of income subject to the federal power."[20]

The attitude of the courts in the matter has been expressed definitely in *Mackintosh v. Flint and Pere Marquette Railway Company*,[21] in which the court made the following statement:

> Income is not limited to the gains which result from business and labor, but it includes as well the proceeds derived from the use or sale of property. . . . The court is unable to understand upon what principle the receipts . . . derived from the surplus land assets are to be distinguished from other income or earnings of the company applicable to the payment of dividends.

Leasehold Improvements as Income of Lessor

THERE are four possible times at which income to the lessor from leasehold improvements made by the lessee[22] may be considered: (1) the time the improvement is completed, (2) the time it reverts to the use of the lessor, (3) the time it is disposed of by the lessor, and (4) over the period of the lease or the time from completion to reversion to the lessor.

The time of completion was required in 1918. A choice between (1) or (4) was permitted in 1921. Some of the earlier court decisions upheld (1); however, in 1935, 1937, and 1938, choice (3) was favored.

In the 1921 Regulations it was provided that:

. . . when buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases: . . .

The stipulation that the improvements be made "in pursuance of an agreement with the lessor" was dropped from the 1934 and subsequent acts. Regulations 86 of 1934 specified the following limitation: "immediately become the property of the lessor in addition to the old stipulation that such improvements are not subject to removal."

The options granted by the 1921 Regulations were:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements.[23]

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof.

The last sentence of (a) was dropped in 1926. Allowance of the spread method as presented in (b) was new in 1921; and, to that extent, the 1921 Law was superior to that of 1918, which permitted no option.

Article 48 of the Regulations of 1921 continues:

If for any other reason than a bona fide purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession or control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements.

Since there was no option in 1918, the word "exceeds" in 1918 was followed by: "fair market price or value thereof to him as determined when the same completed became party of the realty."

In 1932, the Regulations were modified as follows:

Except in cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, . . .

Going on with the 1921 Article:

Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvments, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. . . .

In as much as the 1921 option did not operate in 1918, the Regulations for 1918 were stated differently as follows after the words "destruction takes place:" "fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty. . . ."

An additional paragraph was added in 1932:

In all cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise."

In the 1934 and subsequent acts, options (a) and (b) of 1932 become (b) and (c), and another paragraph (a) was introduced:

(a) The lessor may report as income for the taxable year in which such buildings or improvements are completed their fair market value at the time of their completion."

Additional changes as follows are made necessary:

Except in cases where the lessor has reported income upon basis (a), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor shall report income for the year in which the lease is so terminated to the extent that

the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included.

If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvments, less proper adjustment for depreciation in case option (a) was exercised, and less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See sections 23(e) and (f) and 113(a)(14).

In *Miller v. Gearin*, 258 F. 225 (1919), the Circuit Court of Appeals declared that the lessor received no income at the termination of the lease, and that if any income was derived it was at the time of the completion of the building. Another case decided shortly afterwards leaned toward the idea of the existence of income at the time title to the improvement passed to the lessor.[24]

In 1935, the Circuit Court of Appeals said that income was realized neither on passage of title to the asset to the lessor nor on termination of the lease.[25] The gist of the matter was that income is not realized unless severed from the capital upon which it was based. The judge held that such improvements were similar to any unrealized appreciation. The rule in this case was followed in others in 1937[26] and 1938.[27]

In 1937,[28] the intention of the parties to the contract was considered of primary importance. If the improvements were not required of the lessee, the lessor was said not to have any income when they were made, but only when they were disposed of. If the improvement were required by the lease, it might be considered additional rental.

It is difficult to understand why the intent should govern. Income exists or does not exist and is a fact irrespective of intent.

The Supreme Court in *M. E. Blatt Company v. U. S.*[29] substantially followed the lead of the *Hewitt Realty Company* case and the Phellis[30] case. It said:

So far as concerns taxable income, the value of improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; not income within the meaning of the statute. [It continued:] It may be assumed that, subject to the lease, lessor became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

Following the Blatt case, the Board of Tax Appeals decided improvements made by the lessee are not income to the lessor during the life of the lease.[31]

Life Insurance Proceeds

THE ACT of 1913 stated:

> Provided, That the proceeds of life insurance policies paid upon the death of the person insured . . . shall not be included as income.[32]

The acts of 1913, 1916, and 1917[33] did not apply to corporate beneficiaries. In discussing the 1918 act, the Senate Finance Committee proposed to allow the exemption to all beneficiaries, even to corporations;[34] but the Conference Committee continued the existing exemptions as not applicable to corporations.[35]

In 1921, the right of exemption was extended to corporations.[36] The Secretary of the Treasury in his *Notes on the Revenue Act of 1918*, submitted on November 3, 1919, to the House Ways and Means Committee, explained the change as follows:

> In support of this suggestion it has been urged that business concerns—partnerships and corporations—are no longer allowed as deductions the amount paid for premiums on policies insuring in their favor the lives of officers and employees and that such insurance constitutes a reasonable and proper provision against actual losses which business enterprises sustain in the death of responsible officers and employees.[37]

This provision remained unchanged in 1924 and in later years;[38] except that in the 1926 and subsequent acts, it was definitely stipulated that any interest on proceeds withheld should be included in taxable income.

In 1934, 1936, and 1938,[39] the Regulations were expanded in their treatment of the proceeds from life insurance policies, although the basic idea of exemption was retained. The additional material was designed merely to clarify the provisions and to make it emphatic that: "Only the amount paid solely by reason of the death of the insured is exempted. . . . Any increment thereto is taxable."

Sales of Mines and Oil or Gas Wells

THE 1918 act provided that:

> In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.[40]

This section was instituted to encourage prospecting. A prospector spends much time and money in fruitless search and it seemed unfair to the Senate Finance Committee to tax him at the maximum rate when he locates productive property, as if it were ordinary income attributable to the normal activity of a single year.[41]

The above line of reasoning is similar to that advanced in the case of the taxation of any extraordinary gain in a lump sum; and it has a certain

amount of merit. Perhaps the solution is to furnish some sort of averaging or carry-over provision for all income.

There was no change,[42] except for the rate specified, until the provision was dropped from the 1934 act. The expedient nature of this provision is well shown in the reasons advanced for its elimination. It was omitted because already there was overproduction, and no additional encouragement was deemed necessary to stimulate prospecting.[43]

In 1936 and 1938[44] the provision was reinstated, with a higher rate of tax allowable, but it was limited to oil and gas property only. The reason for reinstatement was that the 1934 act resulted in the prevention of sales of such property and the reduction of tax revenues.[45]

Arbitrary limitations have no plan in a theoretically correct determination; if there is any justification, it must be found in the realm of social purpose.

Sale of Real Property in Lots (Apportioned Costs)

THE USE of apportioned costs for placing an inventory value on individual pieces of property acquired as part of a larger amount at a joint cost was recognized in the Regulations of 1916 and 1917.

The basis:

> . . . shall be equitably apportioned to the several lots or parcels, to the end that any gain derived from the sale of any such lots or parcels may be returned as income for the year in which the sale was made.[46]

And in 1918:

> This rule contemplates that there will be a measure of gain or loss on every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction. . . .[47]

A similar article has appeared in the Regulations for all of the subsequent acts.[48]

Sale of Real Property on the Installment Plan

INSTALLMENT obligations of the buyer are not usually considered as the equivalent of cash (having a fair or readily realizable market value), and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.[49] The dealer may report income on an accrual basis, however, if he does so consistently.[50]

Repossession of Real Property Sold on the Installment Plan

In 1926, 1928, and 1932 the income-tax law provided in the event of repossessions, that

> the entire amount received on installment payments and retained by the vendor, less the sum of the profits previously returned as income and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser, will be income of the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the installment sale.[51]

This provision was the same as in the years of 1918 through 1924 except that in those years the depreciation reduced the basis of the property rather than the profit on repossession.[52]

Some new material was added in 1932 to the effect that:

> If the vendor has previously transferred title to the purchaser, and the purchaser defaults . . . and the vendor reacquires the property, such reacquisition shall be regarded as a transfer by the vendor, in exchange for the property, of such of the purchaser's obligations as are applied by the vendor to the purchase or bid price of the property. Such an exchange will be regarded as having resulted in the realization by the vendor of gain or loss . . . for the year of reacquisition, measured by the difference between the fair market value of the property reacquired and the basis in the hands of the vendor of the obligations of the purchaser. . . . The basis in the hands of the vendor of the obligations of the purchaser so applied will be the excess of the face value of the obligations over an amount equal to the income which would be returnable were the obligations satisfied in full. The fair market value of the property reacquired shall be presumed to be the amount for which it is bid in by the vendor in the absence of clear and convincing proof to the contrary. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition.[53]

This provision remained substantially unchanged in 1934 and 1936,[54] except that the fair market value at the time of repossessions of improvements made by the purchaser was included in gain on repossession and in the basis of the property for future sales.

In 1938,[55] whether title is retained or transferred by the vendor, gain or loss on reacquisition is computed on any installment obligations of the purchaser which are satisfied or applied by the vendor to the purchase or bid price of the property. Gain or loss is the difference between the fair market value of the reacquired property (including improvements) and the basis in the vendor's hands of obligations of the purchaser which are so satisfied, with adjustment for any other amounts realized or costs incurred in connection with the reacquisition.

Disposition of Installment Obligations

Regulation 74 of 1928 stated that:

> If an installment obligation is satisfied at other than its face value or is sold or exchanged, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the amount realized upon such disposition.
>
> If an installment obligation is distributed, transmitted, or disposed of otherwise than by sale or exchange, gain or loss results to the extent of the difference between (1) the excess of the face value of the obligation over the amount of income which would be returnable were the obligation satisfied in full and (2) the fair market value of the obligation at the time of such distribution, transmission, or disposition.
>
> The entire amount of gain or loss resulting from the disposition or satisfaction of installment obligations shall be recognized except as provided in section 112.[56]

This provision has remained substantially the same in all of the succeeding Regulations.[57]

Uncollectible Deficiency Upon the Sale of Mortgaged or Pledged Property

According to the 1918 Regulations:

> Where under forclosure a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price, the difference between the purchase price and the indebtedness will not be allowable as a deduction for a bad debt, for the property which was security for the debt stands in the place of the debt. The determination of loss in such a situation is deferred until the property is disposed of, except where a purchase money mortgage is foreclosed by the vendor of the property. . . . Only where a purchaser for less than the debt is another than the mortgagee may the difference between the debt and the net proceeds from the sale be deducted as a bad debt by the mortgagee.[58]

This provision appears to be sound enough from a tax standpoint to discourage tax-avoidance. The exchange of the property for the debt is not considered an event satisfactory for measuring gain or loss if the mortgagee is the purchaser, and the transaction is not considered closed and complete until the property acquired is resold. However, the transaction is considered closed if the purchaser is a person other than the mortgagee.

The provision was changed in the Regulations of 1921 and 1924 as follows:

> Where mortgaged or pledged property is lawfully sold (whether to the creditor or other purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount[59] as a bad debt for the taxable year in which

it is ascertained to be wholly or partially worthless and charged off. Where a taxpayer[60] buys in mortgaged or pledged property for the amount of the debt, no deduction shall be allowed for any part of the debt. Gain or loss is realized when the property bought in is sold or disposed of.

Accrued interest may be included as a part of the deduction only when it has previously been returned as income.[61]

A bad debt deduction is allowed to the mortgagee if the sale price of the property (whether or not the mortgagee purchases the property) is insufficient to cover the debt and if the remainder is considered uncollectible. Perhaps, this requires an estimate of the possible future resale of the property acquired, if acquired by the mortgagee. Where the property is bought in for the amount of the debt, no gain or loss is recognized, of course.

The Regulations for 1926 through 1938[62] are substantially the same as in 1921 and 1924, except for the changes already noted[63] and additional information regarding the method for computing the gain or loss.

The gain or loss is:

. . . measured by the difference between the amount of . . . those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of . . . proof to the contrary. . . .

In 1937, the Supreme Court ruled that a mortgagee had income to the amount of accrued and unpaid interest covered by a bid made by a foreclosing mortgagee even though the fair market value of the foreclosed property was less than the principal of the mortgage loan.[64] The taxpayer in the case, desired that the cash should be considered a return of capital.

Sale of Patents and Copyrights

The Regulations of 1918 (followed in substantially the same fashion in all subsequent years)[65] specified:

A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and . . . the cost . . . (or other basis). . . . The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of depreciation of such patents or copyrights . . . since the date of acquisition. . . .

Again, as in the case of the disposal of most unamortized asset balances, deduction or addition is required for losses or gains at the time the asset is disposed of, rather than an adjustment of amortization charges of prior periods.

Sale of Goodwill

The Regulations from 1918 through 1938 have remained substantially unchanged in their provision regarding the sale of goodwill.[66] Article 41 of 1921 may be taken as representative:

> Any profit or loss resulting from a sale of good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be determined upon the basis of the . . . assets, including good will. . . . If specific payment was not made for good will . . . , there can be no deductible loss with respect thereto, but profit may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost . . . of the good will sold.

This provision is in substantial agreement with accounting treatment for the sale of goodwill. Theoretically, goodwill deductions should be taken in an amortized amount each period, but, in accounting and tax practice such deductions have been regarded as too uncertain and arbitrary to be used for practicable measurement.

Purchased goodwill is the only goodwill which should be placed on the books or be used to reduce the consideration received on its sale. Such treatment is specified in the above article and in generally used accounting procedure.

Retirement of Bonds, etc.

Prior to 1934, there was no specific mention of this matter, but apparently amounts received by a security holder on the retirement of interest-bearing securities (including those of a government) issued by a corporation were not considered as amounts received in exchange therefor. In 1934, 1936, and 1938,[67] such amounts were considered as received in exchange therefor.

Conversion of bonds to stock of the same corporation does not give rise to recognized profit or loss. The transaction is not considered closed until the stock is sold.[68]

Judgments and Damage Suits

Amounts paid by a corporation on judgments or otherwise on account of damages are deductible. Such deductions are limited to the amount of the damages actually paid and may be taken in the year paid. Any sums received as insurance reduce the amount deductible, of course.[69]

Bad Debts—General

There are two generally recognized accounting and tax methods for charging bad debt losses against current gross income. One method is to

make the charge when a receivable item is determined to be partially or completely worthless. The other method anticipates the time of determination of the loss and makes use of the reserve method for accumulating the expected future loss which is related to current income. The loss is frequently conceived of as a risk cost of doing business, of acquiring income.

These two methods have not always been recognized for income tax purposes, however. In the earlier laws, as we shall see later, only the charge-off method was permitted.

The reserve for doubtful accounts is similar in nature to any reserve for future losses which are associated with current income. It is similar to a reserve for self-insurance. Both self-insurance and bad debt reserves, along with some others, fall into the class of reserves which are somewhere between operating reserves and surplus reserves. The uncertainty regarding the nature of the reserve for bad debts and reserves of a similar nature has been recognized by Professors Kester[70] and Hatfield.[71]

> From the outside it is impossible to say whether this is nearer akin to depreciation or to a reservation of profits. If under the law of probabilities the loss is practically certain to take place, it is logically a deduction for an unrealized but existing loss. If the creation of the reserve was based on a minimum of certainty and a maximum of prudence it represents a reservation of profits.[72]

In spite of this uncertainty as to the true nature of the reserve for bad debts, the reserve method is quite generally preferred over the charge-off method by accountants.[73] Its emphasis on conservatism and business prudence have caused it to be regarded highly for practical use.

The 1913, 1916, 1917, and 1918 acts[74] allowed as a deduction "debts due to the taxpayer actually ascertained to be worthless and charged off within the period."[75] Two requirements are set up: (1) actual ascertainment to be worthless, and (2) charge-off on the books. An amount written off a creditor's books in reducing an account receivable to the estimated value of the debtor's assets was held not deductible as a bad debt under the 1918 and 1921 acts.[76] The reserve method thus was not permitted[77] although the 1916 law and the early Regulations sanctioned the accrual basis of accounting. Apparently the disallowance was based on the idea that bad debts reserves were set up by surplus charges and not subject to accrual and deduction from income.

The 1916-17 acts stated:

> Losses which may be properly deducted from gross income on account of bad or doubtful accounts are those losses which have been definitely ascertained to have occurred and which were charged off during the year for which the return is made. It is not essential that the bad debt or account shall be proved worthless by legal proceedings before the deduction may be allowed, but the corporation must not only be satisfied that the debt or account is worthless but must be able to satisfy the Commissioner . . . that the accounts charged off were

definitely determined at the time to be worthless and that they had not been recognized as worthless or without value prior to the beginning of the year for which the return is made.

The mere writing down of the value of an account does not constitute such a loss as may be allowably deducted. The deduction will be permissible only when the debt or account is written out of the assets of the corporation.[78]

The 1921 act was the same as that of 1918 but added the following words:

. . . (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part.[79]

The Ways and Means Committee favored the change because it felt there was less chance of abuse than under the write-off method required by the 1918 act.[80]

The acts of all of the succeeding years have contained a similar recognition of the reserve method.[81]

The Regulations of 1918 described bad debts, as follows:

Art. 152. Examples of bad debts.—Worthless debts arising from unpaid-rents, and similar items of taxable income will not be allowed as a deduction unless the income such items represent has been included in the return of income for the year in which the deduction as a bad debt is sought to be made or in a previous year. Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt. The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of deduction to be based upon the price he paid for them and not upon their face value.[82]

This regulation was continued in succeeding years.[83]

A number of decisions of the Board of Tax Appeals have held that a taxpayer on a cash basis may not deduct as bad debts interest accrued and unpaid which he has not previously reported as income. By implication, interest accrued and included in income previously may be treated as a bad debt under the same circumstances as any other receivable.[84]

A loss due to the compromise of a claim is deductible where the amount of the claim was previously reported as income.[85] Compromised debts may be deducted if the debtor has no assets out of which the entire amount can be collected.[86] There is no ascertained worthlessness where the creditor for consideration satisfactory to himself voluntarily releases a solvent debtor from liability.[87] Money due on a note is a "debt" for purposes of bad debt provisions.[88] The distinction between bad debt deduction provisions and loss provisions in the income tax is quite artificial.[89] It is the cause for decisions such as those of the Board of Tax Appeals, in which the cancellation of a debt was held deductible as a loss rather than as a bad debt.[90] The Supreme Court held that the sections of the law

on losses and bad debts are mutually exclusive; the amount deductible under one may not be deductible under the other.[91]

The amount deductible is limited to a reasonable addition to the reserve.

What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of that taxable year, those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve. In case subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve should be reflected in the determination of the reasonable addition necessary in the taxable year.[92]

The statute provides no particular manner or method of charging off bad debts.[93]

The mechanical process of keeping accounts is not prescribed by statute. Such accounts may be recorded in an elaborate set of books, . . . or be recorded only in the brain of the taxpayer. It can make no difference as to the form of such operation.[94]

In spite of this statement, no general rule can be drawn, however; most decisions were based on peculiar facts in each case. The gist of most cases is that if books are kept, some form of entry or notation must be made therein.

Both an addition to a reserve and debts ascertained to be worthless and charged off may not be deducted in a given year;[95] however, the total of the two may be deducted if reasonable in amount.[96]

Extraordinarily large bad debt losses are taken care of by G.C.M. 938-A.[97] Where the taxpayer has incorrectly estimated his probable losses and the reserve is found to be insufficient in later years, an adjustment may be made in the following year so that the final balance of the reserve will reflect predictable losses against outstanding receivables. This provision is, of course, a relaxation of periodicity requirements.

The income tax provisions regarding the time for taking the deduction for bad debts are of interest primarily in the case of the write-off method.

Where the facts indicate a debt is worthless and uncollectible and that legal action would probably not result in satisfaction of execution on a judgment, a showing of such facts will be justification for a deduction.[98] The deduction must be written off in the year the debt is ascertained to be bad; deduction in a later year is disallowed.[99] When the statute of limitations prevents the use of amended returns, the above provision works a hardship on the taxpayer. The application of the reserve method is usually more liberal toward the taxpayer, in that strict periodicity has been relaxed by General Counsel Memorandum 938-A.[100]

Deduction may not be disallowed merely because of possible future

recoveries. Such recoveries should be handled as income when collected;[101] or, perhaps, as a credit to the reserve if the reserve method is used. The above treatment is an expedient and desirable deviation from strict periodicity.

Ever since the passage of the 1921 act,[102] deductions have been allowed for partially worthless debts; such deductions have been upheld by the Board of Tax Appeals.[103] A taxpayer, however, is not required to claim partial worthlessness as a deduction in any particular year.[104] Therefore, failure to claim a deduction for partial worthlessness in any year, perhaps, would not prevent a deduction for partial worthlessness in a later year for a greater sum or for total worthlessness.

Bad Debts—Worthless Securities (Except Capital Stock)

UNDER the acts prior to that of 1938,[105] losses from worthless debts evidenced by securities (such as a bond, note, debenture, etc.)[106] were deductible in full as bad debts. This appears to be satisfactory treatment; the mere existence of a formal document does not change the inherent characteristics of a debt.

> Art. 154. Worthless securities.—Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established.
>
> A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuations. Where a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations . . . he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations.[107]

Under the Revenue Act of 1938, losses from worthless debts evidenced by securities are considered as losses from the sale or exchange of capital assets as of the last day of the taxable year and are treated as capital losses. There have been decisions regarding the acts prior to 1938 which upheld the treatment of worthless bonds as bad debts;[108] but in at least one case,[109] the Board raised a doubt as to whether a loss from worthless bonds was properly a bad debt deduction.

Section 23(k) of the 1938 act is as follows:

(1) GENERAL RULE.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection.

(2) SECURITIES BECOMING WORTHLESS.—If any securities (as defined in paragraph (3) of this subsection) are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in section 104, for the purpose of this title, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) DEFINITION OF SECURITIES.—As used in this subsection the term "securities" means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form.

The Ways and Means Committee favored the deduction of worthless securities as capital losses and no deduction for partially worthless debts.[110] The purpose of this change was to bring into agreement the provisions regarding losses from worthless securities with those regarding losses on sales or exchanges of securities.

The Senate Finance Committee's version of Section 23(k) (2) contained the words "in the case of a taxpayer other than a corporation" in place of the words "in the case of a taxpayer other than a bank . . . ," but they were eliminated by the Conference Committee.

The Senate Finance Committee favored allowing corporations to continue to treat such losses as bad debts.[111] It felt that losses of this type are customarily a part of the ordinary business expenses. Furthermore, the more favorable treatment allowed to individuals in regard to losses under Section 117 was not given to corporations. Corporations were permitted to deduct net capital losses only to the extent of $2,000 over the capital gains.

Some pertinent portions of the Regulations[112] relating to section 23(k) are:

. . . No deduction is allowed under paragraph (2) of section 23(k) with respect to a debt evidenced by a security which is recoverable in part. . . .

As used in section 23(k) . . . the term "security" means a bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which (1) is a capital asset as defined in section 117, and (2) has been issued at any time by a domestic or foreign corporation (including that issued by any government or political subdivision thereof), either in registered form or accompanied by interest coupons. . . .

A bond issued by an individual, if ascertained to be worthless, may be treated as a bad debt. . . .

A taxpayer (other than a dealer in bonds or other similar obligations) possessing debts evidenced by bonds of other similar obligations cannot deduct from gross income any amount merely on account of market fluctuation. If a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations (which bonds or other obligations are not securities as defined in this article) . . . he may deduct . . . the uncollectible part of the debt evidenced by the bonds or other similar obligations. A bank . . . may deduct such uncollectible part of the debt even though the evidence of the debt is a security as defined in this article.

Losses on accounts receivable, notes receivable, on bonds of individuals, and on bonds and other securities of corporations are essentially similar. These losses of assets are, in turn, very much like the loss of any other assets, and, perhaps, the best solution is to treat all losses as essentially alike. The objection to taxing or deducting in a lump sum gains or losses accrued over a long period of time could be met by provisions for averaging net income, rather than by limitations on particular types of losses or gains.

Prior to 1938, it was frequently advantageous for a taxpayer to abandon securities as worthless, in order to take advantage of the full bad debt deduction, rather than to sell them for a nominal sum and to fall under the control of "loss on sales and exchange" provisions.

Even before the 1938 act, however, it was held that:

Where a debt secured by a mortgage is compromised by the debtor transferring title to the mortgaged property to the creditor in exchange for a release of the debtor from his obligations . . . , the loss, if any, sustained by the creditor is to be treated as arising from a sale or exchange of a capital asset. . . .[113]

To the extent that abandonment of salvage values is no longer encouraged, the 1938 act is an improvement over its forerunners. As has been suggested, however, it could be improved by making losses from worthlessness and from sales and exchanges completely deductible.

Bad Debts Recovered

In 1916 and 1917 it was provided in the Regulations that:

Bad debts or accounts charged off by a corporation because of the fact that they were determined to be worthless, and subsequently recovered, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. Neither the date at which the debt was charged off nor the fact that it was or was not deducted from gross income in any return made for tax purposes, will in any way affect its character as income of the year in which recovered.[114]

This provision which requires an addition to income for the collection

of bad debts has remained substantially unchanged up to the present,[115] although it has undergone some modification. One change has been made to the effect that recoveries of debts previously deducted from taxable income are not taxable income unless the deduction of the debts in prior years resulted in a reduction of tax liability.[116] The effect is that if the write-off took place in a year of a net loss, any recovery of a bad debt deducted in that year would be included as income only to the extent it was not part of the net loss. For example: if in a given year the net loss was $1,500 and the amount of the bad debts deducted in arriving at such net loss was $2,000, the amount to be added to income in the year of recovery, if the entire $2,000 was recovered, would be only $500. The other $1,500 would be excluded since the tax liability in the prior year was reduced only $500. Whether G.C.M. 20854 will stand or be modified is problematical now that net loss carry-over provisions are once again a part of the income tax law.

The amounts charged off for bad debts are income when collected and not when restored to the books, according to the Board of Tax Appeals.[117] It has been held in several cases that debts collected in later years have no bearing on an earlier write-off.[118] From a practical point of view, a ruling such as this is necessary. Without it, amended returns would be demanded in a great number of cases. In at least one case, however, due to peculiar circumstances, a deduction taken in 1920 was ordered to be reduced by a collection made in 1927.[119]

Although no cases or decisions have been found regarding the applicability of such bad debt recovery rules to the reserve method of providing for bad debts, it would appear that they should not be applicable to other than the write-off method. If the reserve method of providing for doubtful accounts is used, the rates based on experience should take into consideration future recoveries. Any deduction taken as an estimated bad debt provision would then be net as far as future recoveries are concerned.

Future recoveries should be restored to the reserve for bad debts and to the accounts receivable account, and collections should then be handled in the normal way. The result of this procedure is merely to reverse the prior charge made against the reserve. Some accountants modify this methodology and credit the reserve if the recovery is made in the same period as the charge to the reserve, but credit income if the recovery is made after the books for the period of the charge-off have been closed.[120]

Forgiveness of Debt

THE Regulations of the years from 1918 to 1932 have remained substantially unchanged.[121] Those of 1918 stated:

The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, . . . dependent upon the circumstances. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. . . .

In 1934, 1936, and 1938[122] major changes were made. The third sentence quoted above was omitted, and the following took its place:

A taxpayer realizes income by the payment or purchase of his obligations at less than their face value.

The 1938 Senate bill contained a provision which was eliminated by the Conference Committee, to the effect that no gain or loss should be recognized to a corporation from the purchase and retirement of its own obligation. This provision was to be limited to the years of 1938 and 1939.

A further change was:

Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors if immediately thereafter the taxpayer's liabilities exceed the value of his assets.

There appears to be no agreement among court and Board of Tax Appeals decisions regarding the nature of discharges of indebtedness. Some have held that settlements of debt for less than face are income.[123] In other decisions, however, such adjustments were treated as a reduction of cost.[124] The Commissioner refused to acquiesce in these decisions and they were revoked a few years later.[125] Other decisions definitely ruled that amounts cancelled were not income.[126]

The rules regarding gains arising out of forgiveness of debt apply to bonds purchased at less than the issuing price as adjusted for amortization of premiums or discounts on the issuance. In *U.S. v. Kirby Lumber Company*,[127] it was held that where a corporation purchases bonds previously issued by it, at a price less than the issuing price, making clear gain, and there was no shrinkage of assets, the difference is a gain or income for the taxable year. Other recent decisions have been to the same effect[128] and probably supersede many decisions made prior to the *Kirby* case.[129]

As early as 1916 and 1917, the Regulations permitted a deduction for losses incurred when a corporation is required to repurchase its bonds at certain times, and does so at more than par.[130]

In *Dallas Transfer and Terminal Warehouse Company v. Commissioner*,[131] the court said the facts were different from those in the *Kirby Lumber Company* and *American Chicle Company* cases,[132] and held:

In effect the transaction was similar to . . . insolvency or bankruptcy . . . when, upon a debtor's surrendering for the benefit of his creditors, property insuffi-

cient in value to pay his debt, he is discharged from liability for his debt. This does not result in the debtor's acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income.

The reasoning in this case is somewhat confused, but the same approach has been used by others besides the courts.

Perhaps the queerest concept of taxable income brought about by administrative ruling is that of construing a profit out of a corporation's reacquirement of its own bonds at a discount.

From an accounting point of view, the liquidation of a debt by the payment of an amount less than the amount of the obligation does, of course, result in an increase in the net worth as shown by the books of the accountant. To say that taxable income grows out of such showing, however, is to disregard all facts that brought about the decrease in the market value of the outstanding bonds. It would seem that there should be a presumption that the same process that brought about the depreciation in the value of the bonds caused a more or less corresponding depreciation in the value of the corporation's capital assets.

If we must have a tax upon capital transactions, the ultimate liquidation of the corporation will determine whether the stockholder realizes a capital gain. In the meantime the corporation by the reacquirement of its bonds has received nothing with which to pay taxes. Income taxes should attach to a disposition represented by a consummated sale or exchange and not to the incidence of purchase. If otherwise, any purchase at a bargain or subnormal price would result in taxable income.[133]

The general idea that gains should not be measured at the time of purchase but rather at the time of sale is not usable in all transactions. The purchase in most cases represents the beginning of a transaction, and the sale, the end. In the case of issuance of securities, the sale marks the beginning and the repurchase the end of the transaction. Where accruals can not be made because of unpredictability, measurement properly may be made at the end of a complete transaction. The repurchase is a consummated exchange.[134]

The author of the above quotation also objects to taking up gain, because offsetting asset value decreases are not deducted. Ideally, both the gains and the decreases in value should be considered. From a practical standpoint, appreciations and shrinkages are not readily subject to current measurement. A point of realization is picked out for measurement and recognition. Unfortunately, in the above case, the points of measurement for the asset decreases and for the gains on the repurchase of bonds do not happen to occur at the same time. Under our present practice, there is little to be done except to recognize the gain at the time of repurchase of the bonds and to recognize the value loss later when the assets are disposed of at a point where realization for measurement may be said to have taken place for them.

Although the taxpayer receives nothing of exchangeable value, he is discharged from disbursing something of exchangeable value. The equities remaining after paying off some creditors improved their position by the less-than-face settlement. There was an increase in net assets remaining. A recognition of this point was made in the *Lakeland Grocery Company* case,[135] in which it was held that a taxable gain results to the extent of the value of the assets freed from claims of creditors as a result of this type of transaction.

The trend in decisions appears to be toward including gains on the discharge of indebtedness as income.[136] The acts of 1938 and 1939 have provided relief for companies in financial difficulties, when such companies have secured relief by scaling-down agreements with creditors. The law frees them from the necessity of paying a tax on such gains; this provision is merely an expedient and is not a denial that such gains are, in fact, income.

Article 22(a)-14 of the 1938 Regulations provided that income is realized by a discharge in bankruptcy or by agreement among the creditors, if immediately thereafter the value of the taxpayer's assets exceeds the remaining liabilities.

The American Institute of Accountants Committee on Federal Taxation favored the exclusion from the taxable income of insolvent debtors any gain on cancellation of indebtedness.[137]

The Bankruptcy Act of 1898, as amended by the act of June 22, 1938, took care of the matter so far as bankrupts are concerned:

> Except as provided in section . . . of this Act, no income or profit, taxable under any law of the United States or . . . now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this Chapter, be deemed to have accrued to or to have been realized by a debtor. . . .[138]

However, if such a plan has for one of its principal purposes the avoidance of taxes, it may not be confirmed.[139]

The American Institute Committee felt, however, that similar treatment should be given taxpayers who reorganize independently of the Bankruptcy Act.[140]

In 1939,[141] it was provided that after June 29, 1939, to and including the end of a taxable year ending as late as November 30, 1943, corporations may discharge debts represented by bonds, debentures, notes, or other evidences of debt without being taxed on such gain. The corporation must merely satisfy the Commissioner that it was in an unsound financial condition at the time of the discharge; bankruptcy is not necessary.

The privilege is not unrestricted, however; apparently open accounts are not within this provision. The corporation must also consent to the basis for the property as provided in Section 113(b). Since this provision

is optional, the taxpayer may take the gain if he wishes and apply it against other losses, if he has any.

Let it be repeated, these provisions of 1938 and 1939 are designed to aid businesses in difficulty and are not to be seriously considered in determining the nature of income.

Gifts

GIFTS are generally not considered income for accounting or tax calculations, even though the item received has been disposed of for cash.[142] The amount of the gift usually is considered a capital contribution; however, it is difficult to justify gifts as capital when other extraordinary inflows of assets are considered income. Gifts are properly includable within a broad definition of income.[143]

If gifts are considered income, they might fall into either the predictable or unpredictable extraordinary classes. They might even be considered as ordinary recurring income. A situation in which gifts might be considered recurring income would arise if a corporation were to receive a voluntary periodic subsidy or bonus from a municipality, let us say, for keeping selling prices down to a certain point. The gift might then be considered a partial payment for the product. However, it might be objected that subsidies of this nature are not gifts, because of certain services or benefits performed by the corporation to obtain the bonus. The fact that the benefits performed by the corporation and the subsidies of the municipality are voluntary should dispose of this non-gift line of reasoning, however.

In a previous part of this study, all extraordinary gains and losses were associated with the past and not with the future. The determinable event at which measurement was feasible marked the end of a cycle and separated the old assets disposed of from future income calculations. The gain or loss was associated with the assets disposed of, and with the periods during which such assets were held.

However, it is difficult to include gifts in this spreading procedure, because gift assets received have no holding period prior to the time they were received.

It might be possible, however, to consider the holding period for gifts to be the interval between the time the gift assets are acquired and the time they are disposed of. This holding period, perhaps, should be used only for spreading the gain or loss on the disposition (as distinct from the gain by acquisition) of the gift assets.

The 1894 law included gifts and inheritances as income, although it was objected that such items were capital and not a proper object of taxation under an income tax.[144] All of our modern income tax history since 1913 has been marked by exclusion of such items from income.

In all of the Regulations and sections of the 1913 through 1938 acts,[145] the following provision has appeared, and has been upheld by court decisions.[146]

> Money and real or personal property received as gifts, or received under a will . . . , are exempt from tax, although the income therefrom derived from investment, sale, or otherwise is not. . . .

In one of these cases, the judge stated that the Sixteenth Amendment did not confer power on Congress to tax gifts. The assumption underlying this idea is that gifts are capital and not income; that this is so has not been demonstrated, however.

According to present tax methods, the donor of a gift is taxed under a gift tax for the donation; he is allowed no deduction for the gift for income tax purposes. It might be fairer to tax the donee and to allow the donor a deduction, or, at any rate, not to tax him on the gift.

Most accountants agree with the income tax treatment of gifts, because their concept of income places emphasis on the results from ordinary operations. They rule gifts out as income, because such gifts are not the result of the efforts of the organization. This is a narrow view of income. Gifts are a part of the "net increment in capital or assets" and are, therefore, income. The matter of measurement may cause trouble, but, in practice, gift assets frequently are placed on the books at their market value when acquired.

Inflows of assets from gifts should be included in income just as are net inflows from a trade or other transaction. Why should the absence of exchange of consideration in one case and the giving of consideration in another be allowed to dictate different treatment? They are really the same in nature; in one case, the entire inflow is net income; in the other, certain outflows must first be deducted.

Tax-free Exchanges—General

THE BASIC reasons for the provisions regarding non-recognized gains and losses on certain exchanges and reorganizations are (1) easing the inconvenience of taxation when the taxpayer has no readily available ability to pay, (2) prevention of tax avoidance[147] through colorable transactions,[148] and (3) simplification of the problems of income measurement.

In 1933, tax-free provisions underwent much scrutiny and discussion in Congress.[149] It was proposed that they be abolished altogether in order to reduce tax avoidance and in order to simplify the law greatly, and that where immediate payment of the tax on a gain from an exchange or reorganization would be difficult for the taxpayer, the Treasury be permitted to extend the time for payment.

The plan currently used in the income tax at that time did not result in tax exemption; it merely postponed the time for reporting the gain. Tax

avoidance may result when the taxpayer is given the privilege of electing the year for reporting a gain. The Ways and Means Sub-committee[150] felt that realization of income takes place in the year of exchange, and not at a later time, and should be taxed accordingly.

Under the 1913, 1916, and 1917 acts, such gains were taxed at the time of the exchange or reorganization, and the Supreme Court upheld this view. The only objection advanced was that paper profits were being taxed.[151]

Gains were still taxed under the 1918 act when realized, with the exception of certain exchanges of stock for stock. The House defeated a Senate amendment to extend this privilege to other types of transactions.

The first serious change in policy toward gains and losses on certain exchanges was found in the 1921 act. Exemptions were made too liberal in 1921, and tax-avoidance resulted,[152] but some restrictions were placed thereon by amendment in 1923.

Most of our present provisions are built around the 1924 act. Later changes have usually been designed merely to plug loopholes.[153]

The Ways and Means Committee[154] decided it was better to revise drastically the provisions regarding exchanges and reorganization to reduce tax-avoidance rather than to eliminate those provisions altogether. The Treasury felt that elimination would cause a loss in the revenues of the Government and that legitimate transactions would suffer.[155] Litigation and uncertainty connected with a major change of policy probably also caused the Committee to hesitate.

The provisions regarding tax-free exchanges are rather difficult to reconcile with other parts of the income tax system. They are based on the idea of postponing the point at which gains or losses are to be considered realized for measurement purposes. This postponement is in harmony with the non-recognition for tax purposes of other unrealized gains and losses, but it is an exception to the general provision, which states that:

> When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any. . . .[156]

If an exchange would be within the tax-free provisions if it were not for the fact that the property received in exchange consists not only of property permitted to be received without recognition of gain, but also of other property or money, the gain, if any, shall be recognized in an amount not in excess of the sum of the money and the fair market value of such other property.[157]

Non-recognition of gains and losses is not satisfactory from an accounting point of view and can be justified only on the ground of the impracticability of accurate measurement at the time of exchange or dis-

position. Some accountants use the Treasury Department method for trade-ins of fixed assets and capitalize the unamortized balance of the old asset in with the cash paid as the booking price for the assets acquired.[158] Their reasoning is that a strict application of the cost basis for accounting requires both the value of the old asset surrendered and the cash or other consideration to be included in the cost of the new asset.[159] This line of reasoning is similar to that used to justify the inclusion, in some cases, of losses and costs of razing buildings in the cost of land.[160]

In 1931, the Board of Tax Appeals held that no gain or loss is recognized on an exchange of an asset plus cash for a new asset of like kind.[161] In earlier years it was held that the difference between the depreciated value of an old automobile exchanged for a new one and the allowance therefor on the cost of the new car is a deductible loss.[162]

Exchanges of Property of Like Kind or Use

In 1921, it was stipulated that no gain or loss shall be recognized:

> When any such property held for investment[163] or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale) is exchanged for property of a like kind or use.[164]

The Board of Tax Appeals has supported this provision in many decisions.[165]

An exchange of property for that of like kind or use is a closed and completed transaction at which point gain or loss can be measured. The fair market value of the property received can be compared with the basis of the property surrendered.

Solely for expedient reasons gain or loss is not recognized. The act of 1918 recognized such gains and losses, and the result was interference with business and decreases in revenue due to loss-taking.[166]

The 1921 act went too far and it was possible to make an exchange of stock and to receive a profit in cash and still escape taxation. In 1923 an amendment was passed to prevent such tax avoidance.[167]

A 1923 amendment[168] excluded securities from such property exchangeable without recognized gain or loss:

> and in the case of property held for investment, not including stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.

Like kind refers to the nature or character of the property and not to grade or quality.

The Senate discussion of the 1921 act as amended in 1923 indicated that the exchange must merely be of like kinds of property; it is immaterial whether it is held for investment or for productive use; the intention of a person is too difficult to determine.[169]

In the 1924 and later acts was added

> if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation,

there shall be recognized no gain or loss.[170]

Transfer of Property to a Controlled Corporation

AMONG the exchanges on which gain or loss is not recognized are those made when a person or persons transfer property to a corporation and immediately thereafter are in proportional control of the transferee corporation.

This provision appears in the 1921 and succeeding laws.[171] Those of 1934, 1936, and 1938 require that the transfer be made solely in exchange for stock or securities of the transferee corporation. Control has been specified as at least eighty per cent of the voting shares and at least eighty per cent of the non-voting shares.

The corporate entity is overlooked and the transaction is considered not complete and closed and not a satisfactory place at which to determine income objectively. Prevention of tax avoidance by use of colorable transfers is the purpose of this provision.

Involuntary Conversions

THE Regulations of 1918[172] contained the forerunner of the first statutory provision, which appeared in the 1921 act. Prior to 1921, corporations were not permitted by statute a tax exemption in the case of involuntary conversions, although the Treasury Department had allowed it in the practical administration of the law.[173]

This is a restricted privilege, however.

> If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith . . . to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds.[174]

The 1921 act did not grant exemption from tax if the property was replaced in kind by an insurance company or similar person.[175] The 1924 and later laws remedied this oversight, but otherwise remained substantially the same.[176] Gain is recognized only to the extent that the proceeds are not properly expended.

The Board of Tax Appeals has ruled that it is not necessary that the property be reconstructed in exactly the same manner as the destroyed property in order to receive the benefits of this provision.[177]

Exchanges and Distributions in Obedience to Orders of the Securities, and Exchange Commission

IN 1938, as a matter of expediency in relieving taxpayers of undue tax burden and in order to facilitate the work of the Securities and Exchange Commission in effectuating the Public Utility Holding Company Act of 1935, Section 112(b)(8) was inserted in the law to prevent the recognition of any gain or loss resulting from exchanges or distributions ordered by the Commission.[178]

In the 1939 act this provision has been extended to January 1, 1941.[179]

Non-Recognized Losses Only

THERE are certain types of transactions which may result in recognized taxable gain but which may not result in recognized losses for tax purposes.

Property Received in Exchange Consisting Not Only of Property Permitted to be Received Without the Recognition of Gain or Loss, But also of Other Property or Money

IN CASE an exchange of this nature results in a gain, the gain is taxed to an amount not in excess of the "boot" received. The House Ways and Means Committee felt that this limitation does not apply logically, however, to losses; therefore, they are not recognized.[180] This portion of the law has been included ever since 1924.[181]

Wash Sales

NOTHING was stated specifically in the 1916 and 1918 acts regarding wash sales, although those acts did provide that all losses were deductible if not compensated for by insurance or otherwise.[182] In several decisions under the 1918 act, the Board of Tax Appeals held as deductible losses incurred by the sale of securities and a later repurchase in the same day of a similar security for establishing a loss for income tax purposes.[183]

In 1921, the Ways and Means Committee desired to apply wash sales provisions to all types of property but the Senate Finance Committee limited it to stocks and other securities. Section 234(a)(4) of the 1921 act provided:

> No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the pas-

sage of this Act where it appears that within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property.

The intent in setting up a provision such as this and in limiting it to losses was clearly to prevent tax avoidance. Sales of securities and a repurchase the same day gave rise to a deductible loss in 1921 if the transaction was consummated before the passage of the 1921 act.[184]

The 1924 act was about the same as that of 1921 but was more restrictive, in that a "contract or option to acquire substantially identical property" was sufficient to make the wash sale provision operative.[185]

The acts subsequent to 1924 have remained substantially unchanged.[186] In 1932, two very opposite suggestions were made regarding wash sales.[187] One was that the wash sale provision be eliminated altogether. The other, that it be extended to cover a period of one year.

Should Capital Gains and Losses Be Included in Income Determination?[188]

THERE is no agreement among accountants as to the proper treatment of capital gains and losses. Several methods have been suggested: (1) handle as a part of profit and loss, (2) include in the earned surplus[189] (frequently it is difficult to ascertain whether or not such items are to be passed first through profit and loss), and (3) treat as capital surplus items.[190] One writer says either earned or capital surplus is satisfactory, but that such items must not be passed through profit and loss.[191]

The degree of uncertainty in accounting practice regarding the matter has been revealed in a study conducted in 1934.[192] In 294 corporation statements, capital gains were shown in about one half of the cases in the income statement, and in the other half, in the analysis of surplus. Perhaps more cases showed the item as a surplus adjustment.

Earlier treatment was definitely in favor of inclusion in capital surplus. Emphasis at present is on inclusion in earned surplus. There is a noticeable trend, however, toward inclusion of such items in a special section of the income statement.[193] This latter treatment is suggested to increase the clarity and completeness of financial reporting by corporations.

It may be that the economic depression has had something to do with the change from capital to earned surplus inclusion of capital losses. For consistency, perhaps, the treatment of capital gains followed that of capital losses.

Whether capital gains and losses should be (1) recognized at all, (2) given special tax treatment, or (3) taxed as are all other incomes is a subject about which there is much disagreement.

Some believe that government revenues can be increased and stabilized, inflation reduced, the law simplified, tax avoidance decreased, business

encouraged, and greater fairness secured by the elimination of capital gains and of capital losses from the computation of taxable income.[194]

Many of those who favor the elimination of capital gains and losses from tax calculations base their opinion on the fact that Great Britain does not tax such items. Conditions are different in Great Britain, however. There is less speculation and fewer corporate reorganizations than in the United States.[195] Additional care must also be exercised against putting too much emphasis on the British plan,[196] because non-taxation has not worked very well and inclusion of capital items has been considered. Tax avoidance has been accomplished by distorting normal transactions into the guise of capital transactions.[197]

The Joint Committee on Internal Revenue Taxation recommended in 1927 that: (1) capital gains and losses be retained in the tax structure in order that government revenue be preserved, (2) such items be given special treatment in order not to impede normal business, and (3) the existing flat rate system be retained.

Various reasons are advanced by those who desire the retention of capital gains and losses in the tax base.[198] Some advantages claimed are: that it is a good source for tax revenue, that it represents ability to pay, that it is income from a theoretical viewpoint, that capital gains and losses are interrelated with corrections of amortization charges of past periods, that capital gains frequently represent undistributed and untaxed profits, that there is a present need of the Government for revenue, and that there is no clear cut separation in practice between capital gains and losses and other income determination items.

Gains on sales of stock should be taxed; because frequently the sale price is partially composed of undistributed profits which would have been taxable were they distributed. If capital assets were freed of taxation, it would be possible to receive a stock dividend and to resell the shares without tax.

It is difficult to come to any conclusion regarding the advisability of inclusion or exclusion of capital gains and losses in the income calculations for tax purposes. The proponents of inclusion use arguments for inclusion similar to those used by the supporters of exclusion to justify exclusion.[199]

In 1936, one hundred and twenty-seven American professors of public finance were asked to answer certain questions regarding their opinion on proper tax treatment of capital gains of individuals.[200] The questions and answers are summarized below.

	Yes	*No*	*Doubtful*
1. Should capital gains and losses be included?	53	44	30
2. Included and taxed at moderate rate?	37	55	35
3. Immediate abolition of special provisions?	38	66	23
4. Abolition when stock market reaches peak?	4	83	40

If taxation is decided on, shall it be levied in the same manner as on non-capital gains and losses or shall special methods be devised?

Some persons are willing to admit that, perhaps, capital gains are income, but they go on to say that they are so different from other types of income that they need special treatment.[201] Others feel that such items are not properly part of income or should be excluded on other grounds, except that they do represent ability to pay taxes. They are willing to compromise by according such items special tax treatment.[202]

The American Institute of Accountants, from time to time, has advocated the following special treatment for capital gains and losses:[203]

1. Tax capital gains and allow deduction of capital losses.
2. Place in a separate schedule.
3. Tax at a moderate flat rate.
4. Do not use percentages for holding periods.
5. Capital assets should not include land and depreciable assets used in the business.
6. Remove limitations on capital losses.
7. Provide a five-year carry-over of capital losses against capital gains.

Perhaps since capital gains and losses are within a broad concept of income, they should be treated the same as are any other income items. Special treatment within or without the income tax structure would not be provided then. From a social viewpoint, unearned gains should be recognized in full for taxation. From the viewpoint of fairness, capital losses should likewise be deducted in full.[204]

Since inaccuracies in computing ordinary income (depreciation, obsolescence, etc.) inevitably appear as part of a capital loss or gain, capital losses and gains should be treated as are other income items. This interrelationship of errors, gains, and losses indicates that capital items are basically not different in nature from other income-determination items. To grant them special treatment might give rise to manipulations of amortization charges. Theoretically the net cost of an asset should be spread over its life or holding period in amortization charges. If this procedure were practically possible, there would be no such things as capital gains or capital losses.[205]

> There has grown up in accounting a terminology which is at once misleading and meaningless, and has given rise to much of our difficulty in reporting net income. I refer, of course, to the terms "capital gain" and "capital loss." If a company is in the business of manufacturing and selling machinery and during a certain period makes a profit on the sale of securities, there are many accountants who will attempt to make a sharp distinction between the gain resulting from the sale of machinery and the gain resulting from the sale of securities, calling the latter a "capital gain." . . . Do not all gains add to the capital of a business, and, therefore, are not all gains "capital gain?" What those mean who use the terms "capital gains" and "capital losses" is that those gains or losses are of a non-recurring nature. . . .[206]

What I do quarrel with is the treatment often accorded capital gains and losses in our reports—that of making direct credits or charges to surplus.[207]

The entire structure of capital gains and losses should be eliminated. If it is retained, we should recognize that such items differ from other income items only in that, due to measurement difficulties, recognition of gain or loss is made in a lump sum rather than periodically. Perhaps the only justifiable special tax treatment to be accorded such items is to alleviate in some degree the unduly heavy burden which results under a graduated tax rate system. This treatment should be accorded not because such things are capital items but because recognition of gain or loss is made all at once. Any special device used should be applicable to all extraordinary, non-recurring items, whether or not they are called capital gains and losses.

The use of rates which vary according to the holding periods of the assets disposed of (with larger recognition to those held a shorter period) is recognition that the gains and losses of several periods have accumulated and are being taken into the tax computation all at once. The use of holding periods usually causes taxpayers to change artificially the time at which transactions are completed by them.

Some plan of spreading the gain back over the periods held and taxation or deduction at the rates which would have been used in those periods if gains or losses were recognized currently might be devised to take care of the matter.

The Supreme Court has unequivocally stated that capital gains are part of taxable income.[208]

Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. . . . Here we have the essential matter: not a gain accruing to capital; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being derived, that is, received or drawn by the recipient for his separate use, benefit and disposal. . . .[209]

Income has a broader meaning than mere operating income.[210] Under most dividend laws, realized capital gains are considered a proper source for dividends; they should be considered, likewise, a part of the tax base.

Generally, the only capital gains or losses to be included in income determination are those realized.[211] Emphasis on realization causes many tax inequities, however. In some cases two taxpayers may be in the same position before one disposes of property and in the same position afterward, yet only one will be permitted a loss deduction or be taxed on a gain, merely because of some event which has occurred. Form not substance is stressed by such treatment. Either both or neither had a gain or loss as the case may be.

Gain or loss may be said to have accumulated before the sale or other disposal, and in some cases, perhaps, recognition or measurement should be deferred until some time after the disposal has taken place. The income tax law recognized that this may be so in its provisions regarding tax-free exchanges.

Causes of Capital Gains or Losses

So-called capital gains or losses are the result of the same things as are any other extraordinary gains or losses resulting from exchanges. These factors may be listed as:

1. A change in absolute value due to natural growth.
2. A change in value of particular property in comparison with the value of other property due to external causes.
3. A change in money value of property due to appreciation or depreciation of currency.
4. Accumulated errors in asset amortization of prior periods.

All but the third are income calculation items and should be taxed. The third is not an "accretion to purchasing power"; it merely represents a recovery of purchasing power. As a practical matter, all must be treated alike, taxed or not taxed, because we have not yet gained sufficient dexterity in the use of index numbers or other devices for sifting out mere price level changes.[212]

The use of tax-free exchanges results, incidentally, in sifting out of the income calculation some of the mere price level changes.

Gains and Losses from the Sale of Capital Assets

In Article 109 of the Regulations of 1913, capital gains and losses were included in the income calculation:

> In ascertaining net income derived from the sale of capital assets . . . the difference between the selling price and the buying price shall constitute an item to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price.

The Regulations of 1916-1917 repeated the above article[213] and emphasized the matter to a greater extent than previously and indicated that the gain was to be considered as income of the year of the sale.[214]

The 1918 Regulations were quite similar but also made specific mention that proper adjustment would have to be made for depreciation and so forth.[215] No significant changes have taken place since that time.[216]

Definition of Capital Assets

The first definition of the classification of "capital" assets is found in the 1921 act. In prior Regulations, "capital" assets were merely mentioned.[217]

> . . . property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for personal use . . . , or stock in trade . . . , or other property . . . properly included in the inventory . . . if on hand. . . .[218]

This provision remained unchanged until 1934.[219] In 1934 and 1936 the two-year holding period was not included.[220] An important change was made in 1938[221] to exclude from the classification of capital assets:

> . . . property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in sec. 23(1); . . .[222]

The exclusion from capital assets of assets subject to depreciation is commendable. Errors in amortization automatically become capital gains or losses when the assets on which errors have been made, if classified as capital assets, are disposed of. A loss on the sale of machinery is thus fully deductible and abandonment of salvage values is no longer encouraged.

The American Institute of Accountants Committee on Federal Taxation of Income approved the 1938 change, but advocated that land used in trade or business also be excluded from capital assets. Different treatment of land and buildings causes difficult problems of apportionment of proceeds of sales of land with improvements thereon.[223] Assets subject to depreciation are excluded from capital assets under the 1939 act also.

Exclusion of assets subject to depreciation from the capital asset classification should include assets subject to any type of amortization. However, the law would be improved if the entire classifications of capital assets and corresponding capital gains and capital losses were abolished.

In 1932[224] gains or losses from short sales of stocks or bonds, or attributable to privileges or options to buy or sell such stocks or bonds, or from sales or exchanges of such privileges or options, were considered as gains or losses from sales or exchanges of stocks or bonds which were not capital assets.

In later years,[225] they were considered as capital gains or losses of capital assets held one year or less.

For income tax purposes a short sale is consummated when property is delivered to cover the short sale.[226] This treatment represents a variation from the usual situation in which a sale marks a completed and closed transaction.

Tax Treatment of Capital Gains and Losses

In general, special tax treatment for capital gains and losses has not been prescribed for corporate taxpayers. Corporations have been taxed on

capital gains and have been permitted capital losses in the same way as other income and deductions have been treated.[227]

The matter of the treatment of capital gains and losses of individuals is important enough in its implications and possible extension to corporations to warrant examination at this point.

Special treatment was first accorded in 1921.[228] From that point until 1934,[229] capital gains and losses were recognized in full for tax purposes, although the taxpayer had the privilege of choosing a flat 12-1/2 per cent rate applied to such items as a tax computation over and above the tax on all other income exclusive of such capital items.[230]

This privilege was of major importance only to those whose income was large enough to be taxed in part at rates greater than 12-1/2 per cent. In the 1934 act, at a time when little sympathy was expressed for the more wealthy taxpayer, this privilege of special rates for capital gains was withdrawn.

In 1934 and 1936[231] an entirely new method of taxation was introduced. Only limited recognition was granted some capital gains and losses, depending on the period the assets were held.[232] The amounts recognized were then included among the ordinary items and taxed at the usual rates. The same idea was continued in 1938, but the holding periods and rates of recognition were changed.[233]

Special treatment has been accorded capital items, because it has been felt that recognizing such items in a lump at progressive rates was unfair, in as much as they had accumulated over a period of time.

However, special treatment has brought with it new problems, chief among which is the consummation of transactions at times inopportune for purposes other than that of getting the transaction into the most advantageous holding bracket for tax purposes.

As early as 1930, President Hoover said that the current rate on capital gains caused speculative inflation and impeded business recovery.[234] Again, in 1931, he recommended an inquiry into the effects of the capital gain and loss provisions of the law.[235]

Additional evidence of dissatisfaction with capital gains and loss provisions can be found long before the change in 1934. In 1928, the Joint Committee on Internal Revenue Taxation proposed a percentage method of taxation somewhat similar to the 1934 method.

The then existing provisions[236] were criticized on the grounds that they (1) furnished little relief to the smaller taxpayers, (2) were based on mere expediency, (3) ignored the length of the period the assets were held, and (4) often taxed mere changes of price level. This committee said a good system should not impede business and that it should result in a tax approximately the same in amount as if the gain or loss had been realized over the entire holding period of the assets.

Abandonment and Worthlessness as Capital Losses

Article 117-4 of the Regulations of 1934 and 1936 held that Section 117 applied only to gains or losses on sales or exchanges of capital assets. It did not apply to loss of useful life through permanent abandonment of assets or to loss due to worthless stock or debts.

The 1934 and 1936 rules resulted in the absurd situation whereby property was abandoned rather than sold at salvage value, in order to gain a tax advantage of full deduction of loss due to abandonment rather than a partial deduction for a loss on sale or exchange. In two cases, the Board of Tax Appeals attempted to discourage such abandonments by ruling losses not deductible where bonds could have been sold at a nominal price and the taxpayer did not avail himself of such opportunity.[237]

A distinct change in policy took place in 1938.[238] If stock or stock rights were capital assets and became worthless in the taxable year, the loss was considered a loss from the sale or exchange of capital assets on the last day of the taxable year.

Limitation on Capital Losses

In 1916 and 1917, capital losses were deductible only to the extent there were capital gains, and in 1918 this restriction was removed.

In the 1921 act[239] there was no specific limitation on the amount of loss which was permitted to be put into the income calculation. The only restriction was that the 12-1/2 per cent rate when applied against losses should not result in a tax smaller than if the special tax treatment was not used.

In 1921, the taxpayer was taxed at 12-1/2 per cent on capital gains but the deduction for losses was not restricted to that rate, but in 1924, the losses also came within the scope of the 12-1/2 per cent rates. In the years of 1924 to 1932, inclusive, a non-corporation taxpayer was permitted a capital loss deduction only to the extent of capital gains.[240] Corporations had an unlimited capital loss deduction privilege.

A new provision appeared in 1934 and 1936:

> Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges.[241]

No limitation was placed on losses from abandonment.

This $2,000 limitation applied to all taxpayers, corporations included, in 1934 and 1936, but was limited to corporations in 1938.[242] In 1938, for others than corporations, short-term (not over eighteen months) capital losses were allowed only to the extent of short-term capital gains, although a partial carry-over was permitted. There was no limitation on losses on

capital assets held over eighteen months. The above rule was made applicable to corporations in the taxable years of 1940 and thereafter by the 1939 act.[243]

Arbitrary limitation on the deductibility of losses has been the basis for much of the criticism regarding taxation of capital gains and losses. The American Institute of Accountants has favored the relaxation of such rules, at least in so far as they affect sales of assets necessary to the conduct of the ordinary business of the taxpayer.[244]

George O. May has indicated very well in the following statement that there is much justice in the objections raised against arbitrary limitations of capital losses:

> . . . The denial of allowances for losses on property sold is manifestly unjust and results in such absurdities as taxpayers being led to sacrifice substantial salvage values in order to preserve the right to take deductions for losses which are allowable if property is abandoned, but not if it is sold. There is, moreover, something repugnant to one's sense of justice in the sight of a government deliberately devaluing the currency and taxing as a gain the difference between the price received in depreciated currency and the price paid prior to devaluation in the undepreciated currency, and at the same time denying to taxpayers relief in respect of losses occasioned by the fall in prices which is pleaded in justification of the devaluation.[245]

The defense offered for loss limitations is that they are necessary to offset arbitrary or fictitious loss-taking by taxpayers.[246]

Whether or not capital gains and losses are recognized for tax purposes, they should be treated consistently. If one is fully taxable, the other should be fully deductible.

Limitation on Stock and Bond Losses

In 1932, a new provision was introduced into the law.[247] Losses from sales or exchanges of stock and bonds[248] which are not capital assets were allowed only to the extent of the gains from such sales or exchanges. This provision did not affect transactions in real or other personal property.[249] Losses disallowed by the above limitation (not including losses of a preceding year) and not in excess of the taxpayer's net income for the current year were deductible in the succeeding year as losses from sales or exchanges of stock and bonds which are not capital assets.

This carry-over provision was repealed by section 218(b) of the 1933 law on January 16, 1933.[250]

The intention of this provision was clearly preservation of government revenue and discouragement of speculation. Gains from business and other sources were being wiped out by large losses on securities transactions, and it was decided to cut down the allowable amount of such losses.[251]

The proposed House bill of 1932 was very severe and applied the limitation to all securities. The Senate Finance Committee felt that securi-

ties held over two years were held by investors and that they should not be as severely limited as those held a shorter time.[252] Therefore, no change was made in regard to securities held over two years; the limitation applied only to those held for a shorter term.

These limitations on loss provisions were omitted from the 1934 and subsequent acts because of the new policy adopted in the treatment of capital gains and losses.[253]

Unrealized Gains and Losses

Where do unrealized appreciations and value shrinkages of assets fit into the income determination picture? From a theoretical point of view, unrealized appreciations should be included in gross income[254] and unrealized value shrinkages should be deducted. However, they both fall into the group of unpredictable extraordinary items and cannot be measured currently for expedient use. As a practical matter, they are considered only when a sufficiently objective event occurs which marks the end of a cycle and presents an opportunity for measurement.

Opposition to the inclusion of unrealized appreciation in income is very strong among many writers.[255]

Accounting practice has been inconsistent in its refusal to accrue appreciation while it often sanctions the deduction of unrealized shrinkage losses from assets. A commonly stated accounting rule is that an accountant may "anticipate losses but not gains." This type of rule is based on mere conservatism and little more. Conservatism has some value, of course, but should not be emphasized too much when income for tax purposes is being computed.

Shrinkages in value of assets are probably no more accurately predictable or measurable than are appreciations. Shrinkages and appreciations of value are quite similar, except, of course, the price movements are in opposite directions.

Accountants usually limit shrinkage loss deductions to those occurring on current assets,[256] on the ground that they are more certain and subject to measurement than are those related to long-lived assets. However, seldom do they sanction a write-up of current assets. One of the commonest examples of such inconsistencies is the "lower of cost or market" rule for inventory prices[257] and for temporary investments in marketable securities.

There is a minority group of accountants which opposes inconsistent rules regarding write-ups and write-downs. Most of these accountants favor adherence to cost, ignoring both unrealized shrinkages and increments.[258]

The income tax law in 1913 provided that: "All losses actually sustained within the year and not compensated by insurance or otherwise, . . ."[259]

and "losses actually sustained during the year, incurred in trade or arising from fire, storms, or shipwreck, and not compensated for by insurance or otherwise, . . ."[260] were deductible.

A change in 1916 and 1917[261] made the law clear that the above rules applied also to corporations. In these two latter years the deduction was allowed if "actually sustained and charged off." The requirement of charge off was eliminated from an otherwise unchanged provision in the 1918 act by the Senate Finance Committee.[262]

That losses might properly be deducted other than in the year sustained was recognized by the 1921 act, which stated:

> . . . unless in order to clearly reflect the income, the loss should . . . be accounted for as of a different period.[263]

A provision such as this might be construed broadly enough to permit accruals or the spreading of losses over several periods.

However, permission to account for the loss in a period other than that sustained was limited to the 1921 act and was excluded from all of those following.[264]

The 1913 Regulations stated that: "The deduction for losses must be losses actually sustained during the year and not compensated by insurance or otherwise. . . ."[265] Apparently losses actually sustained might possibly include so-called unrealized items, because Article 134 of the 1913 Regulations specified that:

> Depreciation in book values of capital assets shall be treated in the return in the manner prescribed in the case of loss from sale of capital assets but amounts arbitrarily charged off will not be allowed as deductions except so far as they represent an actual shrinkage in values which may be determined to have taken place during the year for which the return is made.

In 1913, also:

> In the case of changes in book values of capital assets resulting from a reappraisal of property, the consequent gains or losses shall be computed for the return in the manner prescribed . . . in the case of the sale of capital assets.
>
> In cases wherein there is an annual adjustment of book values of securities, real estate and like assets, and the increases and decreases in values, thus indicated, are taken up on the books and reflected in the profit and loss account, such readjusted values will be taken into account in making the return of annual net income and no prorating will be required. . . . The adjustment referred to will comprehend assets which have increased in value as well as those which have decreased.[266]

However, Article 158 of 1913 stated:

> Deductions for losses should be confined to losses actually sustained and charged off during the year and not compensated by insurance or otherwise.

The matter was later clarified by an addition as follows: ". . . as evidenced by closed and completed transactions."[267]

The Regulations have placed emphasis on realized items since that

time. They have required that closed and completed transactions must be "fixed by identifiable events."[268] The position of the Treasury Department is expressed well in the Regulations for 1934, 1936, and 1938.

Even though property is not sold or otherwise disposed of, gain (includible in gross income under section 22(a) as "gains or profits and income derived from any source whatever") is realized if the sum of all the amounts received which are required by section 113(b) to be applied against the basis of the property exceeds such basis. On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof the act takes no account thereof.[269]

Although several articles in the 1913 Regulations indicated that unrealized changes in asset values must be considered in income calculations, the regulations were changed in 1916 and 1917 and definitely stated that unrealized shrinkages shall not be deducted.

In the case of banks or other corporations which are subject to supervision by State or Federal authorities and which, in obedience to the orders of such supervisory officers, charge off as losses, amounts representing an alleged shrinkage in the value of property, real, personal, or mixed, the amounts so charged off do not constitute allowable deductions. Deductible losses are those only which are determined upon the basis of a closed or completed transaction. . . .[270]

This rule does not apply to dealers in securities, however.[271] The matter is further clarified thus:

A corporation possessing securities . . . can not allowably deduct . . . any amount claimed as a loss on account of shrinkage in value of such securities through fluctuations of the market or otherwise; the only loss to be allowed in such cases is that actually suffered when the securities mature or are disposed of.[272]

Several Board of Tax Appeals and other decisions have been to the effect that no deductible loss results from appraisals below cost;[273] and that until there has been a sale or other disposition of the property, it cannot be determined whether or not a loss has actually been sustained.[274]

The Supreme Court, in *Gray v. Darlington*, ruled that under the income tax law of 1867:

. . . the mere fact that property has advanced in value between the date of its acquisition and the sale does not authorize the imposition of the tax on the amount of the advance. . . . It constitutes and can be treated merely as an increase of capital.[275]

The Board of Tax Appeals has established the general rule that losses are deductible in the period sustained.[276] The general rule is subject to exception for normal obsolescence, bad debts, and certain other items. Just when is a loss sustained? Over a period of time? Or when discovered?

It has been decided several times that a gain or loss incident to a fire takes place in the year of the fire and not when the insurance is paid.[277]

The excess cost of alterations directly caused by bad faith and incompetence of a contractor in wasting materials and labor was held a capital addition and not a deductible loss when the excess expenditures were made or when they were discovered by comparison with the opinions and estimates of other contractors and with the reasonable value of the alteration.[278]

The discovery date was not considered the time for taking a deduction for losses from embezzlement; the year in which the act of theft took place was considered the proper time.[279]

Losses from the disposition of property are deductible only in the year of a closed transaction. Where a sale is made to a purchaser not related to nor connected with the taxpayer, and no agreement to repurchase exists, the loss is allowable, even though the purpose of the transaction was tax reduction.[280]

To have a closed transaction, it is not necessary that proof be given that there is no possibility of eventual recoupment.[281] This rule is quite generally used for income determination for accounting purposes also. Many so-called completed and closed transactions are not really completed at all, but are considered complete at a point convenient for income measurement.

No gain or loss arises from a mere contract to sell real estate. Sale occurs when the title passes or at the time the possession, burdens, and benefits of ownership are, from a practical standpoint, transferred to the buyer, whichever happens first.[282]

The significance of a sale or other closed transaction in the determination of income has been expressed well in the case of *Schoenberg v. Commissioner*.[283]

> The place of a sale in claiming a deduction is as evidence that a loss has been realized. If the sale is real and is an isolated transaction, it is conclusive proof. If it is only part of an entire plan, then the entire plan is examined to ascertain whether its effect is to produce a loss or a realized loss. It is immaterial that the motive prompting the sale or the plan of which the sale was a part was to secure a deduction. The matter of interest is whether an actual loss has been realized. Tax law deals with realities.

The sale or transaction does not make the profit or loss jump into existence at once; it merely furnishes a convenient place at which the amount of gain or loss can be measured in objective fashion. That such objectivity is important to accounting calculation of income is evidenced by the emphasis on sales as a point of income realization.

The importance of objective measurement in tax matters is expressed in the last sentence of the above quotation: "Tax law deals with realities." Perhaps, it could be clarified if it were stated that objective evidence of

realities is demanded. Reality may not always be measurable. The Treasury's disallowance of many deductions is based on reluctance to accept the unproven estimates of the taxpayer;[284] it is not a denial that some indefinite amount of gain or loss has taken place. However, in the treatment of certain items, the Treasury has been willing to forego its requirement of closed transactions.[285]

The decision in the Schoenberg case continues:

> To secure a deduction, the statute requires an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed—in other words, he has that much less than before.
>
> A loss as to particular property is usually realized by a sale thereof for less than it cost. However, where such sale is made as a part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and identical—it is not real. This is true because the taxpayer has not actually changed his position and is no poorer that before the sale. The particular sale may be real but the entire transaction prevents the loss from being actually suffered. Taxation is concerned with realities and no loss is deductible which is not real.

Similar decisions have been handed down in several other court cases.[286]

Although the Commissioner has refused to acquiesce, the Board of Tax Appeals has also interpreted the significance of the closed transaction as merely a convenient point at which to measure income. It has held that losses may be allowable prior to the year in which the transaction is closed, where they are *reasonably certain in fact and ascertainable in amount.*[287]

A rule such as this is the basis for deductions for predictable losses for bad debts and obsolescence. It cannot be applied to unpredictable losses and gains, of course; because measurement is not possible in advance of the discovery of the loss or gain.

Shrinkage in Value of Capital Stock[288]

In the regulations for all of the years from 1918 to 1938, inclusive, losses claimed on shrinkage in value of securities, such as stocks and bonds, through fluctuation of the market or otherwise may not be deducted. "The loss allowable in such cases is that actually suffered when the securities mature or are disposed of."[289] In 1921 this provision was limited to "stock of a corporation."

Losses allowable under this provision may be limited by other sections of the law.

Worthless Stock

Loss due to worthless stock must be considered as a special case of value shrinkages and subject to exception from the general disallowances of shrinkages.

However, if stock of a corporation becomes worthless, its cost . . . (or other basis) . . . may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made. . . .

The foregoing is part of the 1918 regulations and is representative of the provisions of later years also.[290]

Worthless stock may be deducted only in the year in which it becomes worthless, regardless of when it is ascertained to be worthless.[291] This rule has been interpreted to mean that a loss is actually sustained if it reasonably appears under given circumstances that such stock has become worthless.[292] It is not necessary that there be a write-off on the taxpayer's books.[293]

Under the 1936 and earlier acts, losses due to worthless stock and rights were not subject to the capital loss limitations.[294] If, however, they were sold at a loss, the loss was subject to capital loss limitations. The difference in treatment was aimed at discouraging loss-taking. Worthless items, however, are not within the taxpayers' control, and, therefore, cannot arbitrarily be used for tax-avoidance.

In the 1938 Law, shares and rights were considered securities subject to loss limitations placed on sales of capital assets:

(1) Limitation.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

(2) Securities Becoming Worthless.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this title, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

(3) Definition of Securities.—As used in this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.[295]

Loss of Useful Value

THE following provision appeared in the Regulations for 1918 and remained substantially unaltered in those of 1921, 1924, 1926, 1928, and 1932.[296]

When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost . . . of any asset so discarded (less any depreciation sustained) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where

new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books. . . .[297]

The 1934, 1936, and 1938 Regulations were not greatly different. They made it quite clear that limitations in Section 117[298] regarding the sale or exchange of capital assets were not applicable to losses due to the discarding of capital assets.[299]

Again, the emphasis is on unforeseen losses and not on those which may be considered predictable. This latter type must be recovered over a period of time rather than at the time abandonment occurs.

Losses on the Abandonment of Assets

The problem of abandonment losses is essentially the problem of proper disposal of unamortized asset balances. As in the case of all extraordinary losses, a determination must be made regarding what income periods should be affected by the abandoned asset balance. A decision must be reached as to the time or periods of time in which the loss occurred. The loss is either that of: (1) the holding periods prior to the discovery or taking of the loss, (2) the period in which the loss was realized, or (3) periods subsequent to the realization.

The best theoretical treatment appears to be (1) above, but it is ordinarily not usable.[300] Measurement problems are too great unless the time of abandonment was fixed in advance to allow periodic amortization of the asset over its shortened life.

The third suggestion is made frequently by cost accountants, among others. This point of view may be summarized as:

The abandonment loss is, in effect, a part of the cost of the product which will be turned out by the new machine. Therefore, if it is decided to abandon the old machine in favor of the new one, the abandonment loss . . . should be capitalized as a part of the cost of the new machine and entered into costs through the depreciation charge. The product turned out by the new machine receives the benefit of increased efficiency and should bear the burden of the unrecovered cost of the old machine.[301]

. . . considering the abandonment loss as an expense for the present period, . . . is obviously an untenable view, . . .[302]

To charge . . . to surplus would be to treat it as a loss which is in no way related to future periods. It would seem that this unrecovered cost is not such a loss, however. . . . The cost of previous periods have not been misstated, and although this is an unusual loss, it is definitely related to the future and should be capitalized.[303]

The position of the Government, in general, has been that unamortized asset balances are deductible according to the second method, in the year the asset is abandoned.[304] A well-recognized exception to this rule in both the Federal income tax and in accounting procedure is made in the case of abandonment losses of assets bought with the intention of demolition to make way for other things. They are capitalized properly in the cost of the land, since the price paid for the land was set in consideration of the demolition loss.[305] This rule was followed in one case even though demolition was postponed for a time during which the property was rented.[306]

The Regulations of 1913 stated that:

> Losses due to voluntary removal of buildings, etc., incident to improvements is either a proper charge to the cost of new additions or to depreciation already provided, as the facts may indicate, but in no case is it a proper deduction in determining net income, except as it may be reflected in the reasonable amount allowable as a deduction for depreciation of the new building. Any loss claimed because of the voluntary removal of a building is presumed to have been covered by previous depreciation charges; otherwise the amount of such loss will constitute a part of the cost of the new building.[307]

From a theoretical viewpoint, the loss on abandonment is a proper part of the previous amortization charges but can not be reallocated conveniently thereto.[308] Article 127 of 1913 recognizes that this is true, but it also provides, unwisely, that amounts not so recovered are a part of future asset costs and are not deductible at the time of the abandonment. This provision appears to have included the third best instead of the second best choice.

The Regulations were changed in 1916-1917 as follows:

> Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements will be deductible from gross income, in an amount representing the difference between the cost of such property demolished or scrapped and an amount measuring a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost, less salvage, as would have remained unextinguished had a reasonable allowance been charged off for depreciation during each year prior to its destruction.[309]

The 1916-17 provision permitted the taking of the loss in the year of abandonment, if it had not been recovered previously through reasonable depreciation charges. There is evidenced, however, an apparent disallowance (other than by possible amended returns) of amounts which might reasonably have been included in depreciation charges.

The regulations of these two years, thus, appear to contain recognition that some losses are predictable and currently recoverable. They also recognize that the unpredictable and, hence, unspreadable losses are to

be taken up when the abandonment event occurs, in default of prior current measurement.

In 1918 the regulations remained unchanged,[310] except that specific mention was made that abandonment losses on assets purchased with abandonment in mind were properly includible in the asset cost of the land.

In the 1921[311] and subsequent regulations, the explanatory material regarding the computation of the loss as an amount less reasonable previous depreciation write-offs was removed. It is problematical whether or not this alteration makes it possible for the entire amount of unrecovered asset balance to be deducted even though part of the balance is made up of asset cost which should have been recovered previously by depreciation charges on the predictable shortening of the asset service life.

Unamortized Balances

In order that all unamortized asset balances may be handled in a manner consistent with the tax treatment permitted for losses on the disposition or abandonment of fixed assets, any unamortized balances of expenditures should be recognized at the time they may no longer be deferred. Theoretically, the best treatment is an adjustment of past amortization figures to absorb the amount not absorbed in the past.

The depreciated cost of non-removable improvements erected on leased premises is deductible by the lessee on the expiration of non-renewable leases.[312] Where a new lease required the razing of an old building and the erection of another, it was held that the lessee may not spread the unamortized cost of the old improvements over the new lease. The unamortized amount is deductible in the year of the demolition.[313] Several other decisions have been rendered permitting a deduction of unamortized improvements by the lessee when a lease is cancelled.[314]

However, in contradistinction to the above cases was one in which the unextinguished cost of an original lease was considered part of a new one on the same premises and proratable over the new lease.[315]

There is some agreement in accounting rules that unamortized bond discount on bonds retired should be written off in the year of retirement.

> Ordinarily bond discount should be amortized over the life of the bonds, but if any of the bonds are retired before maturity, the unamortized portion of such bond discount applicable to the bonds so retired should be charged off to profit and loss during the year of their retirement.[316]

Carman Blough stated in 1937:

> Bond discount and expense attributable to reacquired long-term debt is required to be written off when the bonds have been reacquired, irrespective of whether they may be subsequently resold.[317]

There is no such agreement, however, regarding the treatment of unamortized discount on bonds refunded by other bonds or by shares. The present uncertainty has been stated well by George O. May:

> In the case of a refunding issue, some take the view that the retirement of the old bond issue completes a transaction which began with its issue—just as the discarding of a piece of machinery through obsolescence completes a transaction which began with its purchase. Others take the view that the refunding is a voluntary action which will produce an economy in that the cost of the money borrowed over the remaining years of the term of the original issue will be lessened by the refunding, even if the amortization of the old discount and expense be included as a part of the cost in this calculation. On this basis, they hold that the unamortized discount and expense . . . may be . . . written off over . . . the future . . . ; the other school argues that it involves carrying forward an asset or deferred charge which should be written off.
>
> Each view . . . has substantial support among accountants.
>
> In such circumstances, it seems impossible for the Institute to lay down a uniform rule for the guidance of its members, and it is noteworthy that the Securities and Exchange Commission has also refrained from laying down any general rule on this question.[318]

The American Institute of Accountants Committee on Accounting Procedure, in 1939,[319] allowed a write-off at the time of refunding, but preferred the distribution of such items over the original life of the bonds refunded. Their preference for this instead of amorization over the life of the new bonds is based on conservatism.

Another accounting opinion expressed was that the unamortized balance of bond discount and expense on reacquired bonds should be deferred over the remaining life of those bonds. However, this opinion favored the deferring over the life of new bonds any premium paid on the old bonds repurchased, as a cost of issuing the new bonds.[320] Such treatment seems inconsistent. Both items should be treated alike; unamortized discount is a form of premium on repurchase.

There is additional support to be found among accountants in favor of writing off such balances over the remaining life of the old bonds repurchased.[321] In contrast to this, there is also accounting opinion in favor of writing off unamortized discount and premiums on the repurchase of bonds over the life of the new bond issue.[322] One opinion is as follows:

> If the new bonds are merely a substitution and were not issued to the public through the usual financial procedure, the deferred discount and expense on the old bonds at the time of refunding will not be allowed as a deduction for income tax purposes after the refunding date. The treasury department has been upheld in its contention that where a new issue of bonds is used to retire an old issue by substitution only, all deferred discount and expense of the old issue must be regarded as a deduction for income tax purposes in the period prior to the date of refunding.[323]

In many cases the Commissioner disallowed the deduction for unamortized bond discount, but in some of them, the Board of Tax Appeals and the courts upheld the taxpayers. Treasury Decision 4603 was then issued in 1935.[324] The gist of this decision follows in the following paragraphs.

(a) Any premium on redemption, less unamortized premium upon issuance (not already returned as income), plus any unamortized discount or expense is deductible in the year of the retirement of the bonds. This rule is supported by several decisions.[325] The treasury decision further provides that in the case of the retirement of old bonds before the date of this treasury decision, the tax is to be based on the rule heretofore in effect; *i.e.*, the items should be prorated over the life of the new bonds if the tax year of the retirement is closed on that basis and the tax cannot be redetermined; and if such taxable year remains open, the taxpayer may elect the old basis.

(b) A different rule applies for bonds retired by cash and the issuance of new bonds. In regard to the portion retired by cash, any amount in excess of the face value of the old bonds, less premium received on the issuance (and not already returned as income) plus any unamortized discount and expense on issuance is deductible in the year of retirement, subject to provision (a). In regard to the part retired by the issuance of new bonds, such items shall be amortized over the life of the new bonds.

(c) In the case of the retirement of old bonds in exchange for new bonds of the same or greater face value, or by exchange for new bonds plus a bonus in cash, such items shall be amortized over the life of the new bonds.

(d) In the case where old bonds are retired from the proceeds of the sale of stock, such items are deductible in the year the bonds are retired.[326]

In the case of the retirement of old bonds through conversion or exchange for capital stock of the obligor, no deduction is allowed on account of unamortized discount either when retired or in the future.[327] Apparently conversion is considered a continuation of an existing transaction, while sale of shares and the use of the proceeds to redeem old bonds are considered distinct transactions marking a point at which gain or loss may be measured.

Considering the differences of opinion among accountants, and between the courts, the Board of Tax Appeals, and the Treasury Department, perhaps, it is not necessary that a decision on the matter be reached here. Suffice it to say, the real choice appears to be between a write-off at the time of retirement and amortization over the life of the new issue. If such items are deferred to the future, it is on the theory that they represent costs of issuing the new bonds. The cost should, therefore, be spread over the life of those bonds and not over a more conservative shorter period.

To be consistent with the treatment of obsolescence, such discount and expenses should have been recovered during the time the bonds were outstanding. Failing that, they should be written off at the time the bonds are retired.

Basis[328] for Determining Gain or Loss on Disposal of Assets

THE GENERAL rule is that the proper basis of assets for determining gain or loss shall be cost[329] or approved inventory value, adjusted for certain things.[330] The principal exceptions to the general rule are encountered in connection with property received on tax-free exchanges.

The basis of property received tax-free after exchanges for substantially similar property is the basis the old property had,[331] decreased by the amount of money received in the transfer and by the loss recognized at the time of the exchange and increased by any gain recognized at the time of the exchange.[332]

If any exchange was tax-free, because the property received had no market value[333] or "readily realizable market value,"[334] the property received assumes the basis of the old.

In cases of involuntary conversion, the property acquired in the manner provided by law is treated as taking the place of the property converted.[335] The basis is the same as that of the property converted, decreased by the amount of any money received and not properly expended and decreased by the amount of loss to the taxpayer recognized upon the conversion and increased by the amount of gain on conversion.[336]

The basis of stock or securities acquired in wash sales transactions is the basis of the items disposed of, increased by the excess of the repurchase price over the sale price, and decreased by the excess of the sale price over the repurchase price.[337]

Property acquired by a corporation after December 31, 1920, in exchange for the issuance of its securities[338] has the same basis as it had in the hands of the transferor, increased by any gain or decreased by any loss recognized to the transferor at the time of the transfer.[339] This rule applies also when part of the consideration for the property is money, in addition to the stock or securities.

In 1932, the Ways and Means Committee[340] amended the law to reflect the long established position of the Treasury in regarding the basis of property transferred to a corporation as paid in surplus, as the same basis as that of the transferor. This amendment removes the effect of a Board of Tax Appeals decision that the basis was the fair market value of the property at the time of transfer.[341]

The 1918 Regulations[342] specified that the basis for property acquired by gift or bequest was the fair market value at March 1, 1913, or at the date of acquisition. Fair market value is evidenced by the appraised value for Federal estate or state inheritance taxes.

In 1921, separate treatment was provided for (1) gifts made on or before December 31, 1920, (2) gifts made after December 31, 1920, and (3) inheritances and bequests.

Gifts made on or before December 31, 1920, have as a basis the fair market value at the time the property was transferred.[343]

Gifts made after December 31, 1920, assumed the basis the property had in the donor's hands or in the hands of the latest owner who was not an owner of the property by gift.[344]

The 1934, 1936, and 1938 Regulations state:

The time of the gift is the time when the gift is consummated. Delivery, actual or constructive, is requisite to a gift. In determining the time of the gift, the passing of title by the donor is not decisive; the time when the donor relinquishes substantial dominion over the property is decisive.[345]

The rule for gifts made after December 31, 1920, was changed in 1934 to prevent tax avoidance, whereby a person with a small income might transfer property which has declined in value, to a person with a large income.[346] The 1934 rule was the same in the case of gains; but

. . . for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower, . . .[347]

According to the acts up to 1928,[348] property received by bequest or inheritance assumed the fair market value at the time of acquisition; in the 1928 and subsequent acts,[349] the basis is the fair market value at the time of death.[350]

Property acquired by a corporation during a period of affiliation[351] from an affiliated corporation shall have the same basis as in the hands of the corporation from which it was acquired.[352] This is true whether the property was sold or disposed of during or after the period of affiliation.

The 1932 and later provisions are the same, but they add:

This rule is applicable where the basis of the property is material in determining tax liability for any year, whether a separate return or consolidated return is made in respect of such year.[353]

The basis for property thus acquired in the tax year of 1929 or later in connection with which a consolidated return was made or required under Regulations 78 or 75 shall be determined in accordance with such regulations.

The general theory is that where no gain or loss is recognized on an exchange, the new property shall take the place of the old.[354] If money is received and not taxed, it must be considered as a reduction of the basis. If money is received and taxed, the basis should not be changed.

Since under the income tax, tax-free exchanges are considered to be merely a continuance of a transaction and not the ending of an old and the start of a new transaction, it is logical to require that the basis be left unchanged.

A new section[355] in the 1939 act has been introduced in order to make certain that all income is accounted for at some time or other. It provides that the basis of properties of a corporation which excludes gain on the

discharge of indebtedness under Section 22(b)(9) must be reduced by the amount of the excluded gain.

The basis provided for assets must be adjusted for certain events and transactions which may have occurred between the time the assets were acquired and the time of their disposal.

The basis must be increased by the cost of capital improvements and betterments and carrying charges (such as taxes on unproductive property).[356]

Decrease adjustments must be made for depreciation and similar deductions previously taken[357] (such as for exhaustion, wear and tear, obsolescence, amortization, and depletion[358] allowable, whether or not claimed or allowed),[359] and distributions previously made in respect of stock.[360]

Depreciation and depletion were included as proper adjustments as early as 1918,[361] but more complete provisions regarding adjustments to the basis of property were stricken out of the proposed bill for 1921, on the ground that such items were self-evident and specific mention superfluous.[362]

The detailed provision introduced in 1924[363] was merely a formal inclusion in the statute of the construction placed on the existing law.

The 1918 and 1921[364] regulations have interpreted the meaning of "market value" as used in the income tax provisions, as follows:

> Market value is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade.
>
> Property received in exchange for other property has no fair market value for the purpose of determining gain or loss . . . from such exchanges when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion.
>
> It does not follow that property has no fair market value merely because there is no price therefor established by public sales or sales in the way of ordinary business.
>
> The nature and extent of the sales and the circumstances under which they were made should be considered.
>
> Property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property.
>
> Property which is regularly traded in a public market has a readily realizable market value in the quantities regularly traded in.
>
> Property may be salable, as in the case of a forced sale or in exceptional quantities, without having a readily realizable market value.

Basis for Shares of Stock Sold[365]

There are four general methods for costing-out securities sold: (1) actual identification, (2) first-in, first-out, (3) average cost price of block from which shares are sold, and (4) last-in, first-out.

The first two methods are recognized by the Bureau for income tax calculations. Actual identification is the preferred method where identification of shares sold is possible.[366] Where stock is purchased at different times and a part is sold and the identity of the shares sold is not determinable it is presumed that those sold were those first acquired.[367]

There has been some objection to the arbitrary requirement of either of the first two bases for the shares. The first two methods are very widely used in accounting practice, but, perhaps, the theoretically best method is the average method.[368] Average cost is preferred by both the New York Stock Exchange and the Securities and Exchange Commission.[369]

The income tax regulations[370] also recognize the actual identity method first and the first-in, first-out method as a second choice:

> When shares of stock in a corporation are sold from lots purchased at different times and at different prices and the identity of the lots can not be determined the stock sold shall be charged against the earliest purchases of such stock. . . . Where common stock is received as a bonus with the purchase of preferred stock, or bonds, the total purchase price shall be fairly apportioned between the stock and securities purchased for the purpose of determining the portion of the consideration attributable to each class . . . but if that should be impracticable . . . , no profit on any subsequent sale . . . will be realized until . . . have . . . recovered the total cost.[371]

A discussion of the treatment of stock dividends and the right to subscribe to shares is contained in Chapter VI of this study.

> Any distribution (whether in cash or other property) made by a corporation to its shareholders . . . otherwise than out of (1) earnings or profits . . . (and is not a dividend)[372] . . . shall be applied against and reduce the basis provided . . . for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.[373]

A provision substantially the same as this has appeared in every act since 1921.[374]

A return of capital should be considered a reduction in the basis of total capital in order that gains or losses may be computed on the disposition of the remaining capital. Hence, there is little objectionable in this statutory provision.

Chapter Summary

The Federal income tax has always been a tax on income from all sources (some exceptions have been made, however). Capital gains and losses, leasehold improvements, the results of sales of mines and oil or gas wells, the results of real estate sold in lots or on the installment plan, the results of repossession of property sold on the installment plan and the disposition of installment sales obligations, uncollectible deficiencies on the sale of pledged or mortgaged property, the results of the sale of patents and copyright and goodwill, bad debt losses, worthless securities losses, forgivenesses of debt, losses of useful value of assets, abandonment losses,

unamortized balances of assets, and other non-recurring items are all included as either gross income items or as deductions from income in some degree or other.

Such items have been subject to certain arbitrary limitations and other provisions. One large class of items has been entirely eliminated from the usual net income computations; perhaps, it would be more proper to say that such items are used in income determination but are postponed beyond the usual time for recognition.

Leasehold improvements made by a lessee are income to the lessor. The time for recognizing such gains has varied in the several acts. In 1918, income was taken in the year the improvement was completed. In 1921, the option of spreading the income over the term of the lease was introduced. The trend in the last several years has been toward non-recognition of gain until the asset is disposed of, unless the improvement is required by the lease. If the latter circumstance is present, such improvements are to be spread as additional rent.

Interest on the proceeds of life insurance is taxable. Only the 1921 and subsequent acts have been applicable to corporations.

Profit or loss on the repossession of real estate sold on the installment basis has always been recognized at the time of repossession. The time of disposition marks recognition of gain or loss on installment obligations.

An uncollectible deficiency upon the sale of mortgaged or pledged property in cases where the entire balance of the debt is not collectible have been given different treatment at different times. In 1918, no bad debt deduction was permitted where the mortgagee bid in the property at foreclosure, even though the price was less than the face of the debt. Since that time, the mere fact that the mortgagee is the bidder has not prevented recognition of gain or loss.

The time of disposal has, likewise, always been the point at which gain or loss is taken up on the sale of patents, copyrights, and goodwill. The basis for goodwill must be definitely proved.

Before 1934, amounts received by security-holders on the retirement of bonds were not considered as amounts received on the sale or exchange therefor. Since that time, the opposite has been the rule. Since 1918, no profit or loss is said to arise when bonds are converted into capital stock of the same corporation until the stock is disposed of.

Payment on judgments are deductible in the year the payment is made. Lease improvements made by a lessee are deductible by the lessee at the termination of the lease (adjusted for depreciation, etc., of course).

In many cases the Commissioner has disallowed the deduction of unamortized bond discount but frequently has been reversed by the Board of Tax Appeals. In 1935, a treasury decision was issued which clarified the situation immensely. The premium on redemption of bonds, less unamor-

tized premium on the issuance, plus unamortized discount or expense on the issuance may be deducted at the time of retirement in the case of bonds retired after a cash purchase. Amortization over the life of the new bonds is specified when old bonds are refunded by new bond issues. Bonds retired with the proceeds of a capital stock issue require deduction of the unamortized discount at the time of retirement. The refunding of bonds directly by stock issues causes unamortized discount to be ignored at the time and to be incorporated in the basis of the stock issued.

In the preceding cases, gain or loss has been recognized at some identifiable event when a transaction may be said to have been completed and closed; accrual has not been permitted. The same sort of rule has been followed in the case of most unrealized items. Shrinkages in values of capital stock and losses not actually sustained are not deductible. A court decision in 1934 and a Board decision in 1933 emphasized that a closed transaction is important as a reliable point for measurement of income or loss; however, the Board indicated that such point need not be awaited if a deduction estimate was reasonably certain in fact and ascertainable in amount.

Worthless stock and losses of useful value of assets upon abandonment are exceptions to the general rule, or, at least, are special cases. Such items are not ordinarily subject to an exchange but are dependent upon a different type of event. They have always been deductible in the year of worthlessness or abandonment; except that in 1913, abandonment losses were required to be deferred to the future by being capitalized in the new asset.

Losses on assets purchased with the intention of abandonment have been considered as properly subject to being capitalized in the new asset. This treatment is also accorded to losses and gains on assets which are ordinarily traded in for new assets.

Tax-free exchanges furnish a major deviation from the usual rules of gain and loss recognition; recognition is delayed beyond the usual point. The assumption is made that, at least for practical purposes, the usual point of measurement is not objective enough or convenient enough for use in taxation. The transaction is considered continuing and not completed and closed.

From 1913 to 1918, there was no such general class of tax-free transactions, and gains and losses were taxed when realized. The 1921 law moved far away from the old position, however, and tax avoidance followed. An amendment in 1923 restricted the tax-free privileges. The 1934 act furnished the basis for our present provisions; succeeding changes have been made in the interests of clarity and the plugging of loopholes.

Gains and losses on involuntary conversions (where the proceeds are properly reinvested) of property and transfers of property to a controlled

corporation have not been recognized since the acts of 1918 and 1921, respectively. The 1938 and 1939 acts excuse from recognition gains or losses made in conformity with the orders of the Securities and Exchange Commission.

No gain or loss was recognized in the 1921 act on exchanges of property of like kind or use. Securities were excluded from this privilege in 1923, but were reinstated to a limited degree in the acts from 1924 to 1938, inclusive. In these latter years, exchanges of common stock for common stock and preferred stock for preferred stock, of the same corporation, were the only security transactions to be given the tax-free status.

Losses from wash sales were deductible in 1918 but have not been since that time. Gifts have not been considered taxable income under our present income tax system since it was instituted in 1913.

Sales of real estate on the installment plan may be reported on the installment sales method and a percentage of the collections returned each period. This provision has been in our law since 1918.

From 1913 to 1918, the charge-off method for bad debts was required. In the 1921 and subsequent acts, partial worthlessness and the reserve method for bad debts were recognized. This recognition is a deviation from the emphasis usually placed upon the event which marks the completion of a transaction.

Worthless securities evidenced by stocks and bonds had, since 1918, always been treated as bad debts; but in 1938 they were required to be treated as losses from sales or exchanges of capital assets. This change was intended to bring worthless security and sale and exchange provisions into harmony. Abandonment of salvage values is thus no longer encouraged.

In the years from 1916 to 1938 inclusive, bad debts recovered have been considered income in the year of recovery.

From 1918 to 1932, income did not include gains to a debtor from the forgiveness of debts by his creditors. Since the 1934 act, such gains have been considered income, although consideration has been given in 1938 and 1939 to companies in financial difficulty.

Special tax classifications of "capital" assets, capital gains, and capital losses have been set up in the income tax law. From 1921 to 1934, only assets held two years or more were considered capital assets. This two-year period was dropped in later acts, because other changes in the law made this period unnecessary. Inventoriable items are not included, and since 1938, assets subject to depreciation have also been excluded.

Special tax rates have not been applied to corporation capital gains as has been the case with those of individuals; however, certain limitations do affect corporations.

In 1916 and 1917, capital losses were permitted only to the extent

there were capital gains. The restriction was removed in 1918, and from 1918 to 1932 corporations enjoyed the right to an unlimited capital loss deduction. In 1934, 1936, and 1938, they were restricted to the extent of capital gains and $2,000 more. In 1939, the 1938 rule applicable to individuals was applied to corporations also. Short-term capital losses are allowed to the extent of short-term capital gains (with a partial carry-over) and long term capital losses are not subject to limitation.

In addition to the discussion in the present chapter, additional matter concerning non-recurring items can be found elsewhere in this work. Chapter III contains a discussion of reserves; Chapter IV, income realization; Chapter VI, items affecting corporations in their capacity as shareholders in other corporations; and Chapter IX, justification of "spreading" procedures.

CHAPTER VI

THE ACCOUNTING ENTITY

A CONSISTENT AND LOGICAL SOLUTION for many problems of income determination rests upon the consistent use of a proper concept of the accounting entity.[1] What is the proper accounting entity when corporation net income is being determined?

There are three possible nuclei about which corporate net income computations may be gathered. The first of these is the legal corporation entity; the second is the "association of shareholders." Both of these are concerned with particular corporations only.

The last of the three nuclei is the entity about which interrelated economic operations and relationships are constructed and interwoven. There are sufficient weaknesses in the first two choices to make their use inadvisable. The third choice, the economic entity, appears to be most satisfactory.

Legal Entity

EMPHASIS placed on the separateness of the business entity does not mean that the business entity and legal entity are synonymous. However, such has been held by the courts, although even they have recognized that, on occasion, the legal entity may be overlooked. Some citations given below indicate the attitude of the courts on the question.

> If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons.[2]
>
> The corporation will be regarded as a legal entity as a general rule, and the courts, acting cautiously and only when the circumstances justify it, will ignore the fiction of corporate entity, where it is used as a blind or instrumentality to defeat public convenience, justify wrong, or perpetrate a fraud, and will regard the corporation as an association of persons. . . .[3]
>
> . . . the fiction of corporate entity may be disregarded where one corporation is so organized and controlled and its affairs are so conducted that it is, in fact, a mere instrumentality or adjunct of another corporation.[4]

The legal entity rule appears to be one of convenience and not one which expresses fact.

Association of Individuals

GEORGE R. HUSBAND, one of the chief advocates of this concept, stated his theory as follows:

For purposes of economics and accounting, the corporation might well be viewed as a group of individuals associated for the purpose of business enterprise, so organized that its affairs are conducted through representatives.[5]

This concept may be satisfactory for closed corporations, personal holding companies, and similar closely-controlled companies in which stockholder control is virtually equivalent to that of a partner or single proprietor. In fact, under certain circumstances, the Federal income tax provisions have overlooked the separate entity of such groups.[6]

It has been suggested that both corporations and partnerships be taxed alike,[7] either as partnerships or as corporations[8] are now taxed.

Except in the case of closely-controlled corporations, the status of stockholders is not similar to that of a partner in a partnership. There is no immediate and effective control by individual shareholders. Rather, they have about the same status as does any other capital contributor known as a creditor.[9] Since there is a difference between shareholders of an ordinary open corporation and those of a closed corporation and partners and single proprietors, such open-corporation shareholders should not be taxed on the corporation income merely because it is income of the corporation.

Open corporations have an exclusive existence and are a separate body distinct from the shareholders.[10] It has been suggested that there is a business entity in *any* enterprise, distinct from the human beings associated with that enterprise. This viewpoint has been carried far enough to include single-proprietorships and partnerships, as well as corporations.[11]

George R. Husband has discerned that there is something in common between corporations, partnerships, and sole proprietorships. However, he relates this common characteristic with the individuals (association of individuals) rather than with the distinct business entity common to all forms of business enterprise.[12]

Economic Entity (Business Entity)

In computing the income of a corporation, the entity of the business must be considered more important than the mere "association of shareholders." The entity to be given consideration is not the mere legal entity of the corporation, however.

The entity upon which accounting calculations should be based is founded on the idea that an enterprise has an existence apart from its human operators and not necessarily bounded by the legal entity. In short, this idea of an entity need not be limited to income calculations for corporations but may be extended to those made for any form of business enterprise.

The economic or business entity embraces all related business enter-

prises and economic activities which may be said to fall under unified business control. It may transcend the mere legal corporate entity and include several corporations or other enterprises pursuing related economic activities under common direction.

Proceeds of the Original Issuance of Capital Stock

The Federal income tax always has provided that the total consideration received on the original issuance of shares is to be considered capital and not income. Premiums received are not income; discounts allowed are not deductible.[13]

Accountants[14] and the Board of Tax Appeals[15] agree that discounts and premiums are capital and are not to be amortized to income. Forfeited stock subscriptions have been held to be capital and not income.[16]

Contributions by Shareholders

Contributions by shareholders are capital under the Federal income tax, as well as under accounting rules:

> Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstance are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the company.[17]

It has been held in many decisions that the cost of shares may be increased by the payment of assessments or decreased by liquidating dividends or otherwise. The additional cost of the stock is recoverable when the shares are sold or become worthless; such additional cost is not a loss when the expenditure is made.[18] However, if a stockholder is forced to make the advance to a corporation from which he cannot expect a return, the amount advanced may be deducted as a loss when made.[19] In one case, a court decision was handed down to the effect that property conveyed to a corporation by its shareholders was to be considered a gift.[20]

Forgiveness of a Debt Owed by a Corporation to a Shareholder

The regulations of all of the years from 1918 to 1938, inclusive, have regarded the foregiveness of corporate debts by a shareholder as equivalent to additional contributions of capital, and, therefore, not taxable to the corporation.[21] This rule has been upheld by the Courts and the Board of Tax Appeals in several decisions.[22]

Gains or Losses on Reacquired Shares

The Regulations for 1916 and 1917 provided that gains or losses on treasury shares should be included in the income calculation.[23] This provision was supported by the opinion of the local Collector of Internal Revenue of Los Angeles.[24] Exception was made to exclude from income gains or losses on transactions in shares donated to the corporation for the purpose of raising working capital.[25]

For the years of 1918 to 1932,[26] inclusive, the regulations provided that gains or losses upon the acquisition or disposal of reacquired shares were capital items and did not affect taxable income. The Regulations were:

> If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock.

Beginning with the regulations of 1924, the words "or sale" were inserted in the last line.

A changed and more realistic provision appeared in 1934, 1936, and 1938:[27]

> Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. . . . But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed . . . as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in the satisfaction of indebtedness to it, the gain or loss resulting is to be computed . . . as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the act.

Decisions concerning the acts prior to that of 1934 were overwhelmingly in support of the idea that corporation net income is not affected for tax purposes by purchases or sales by a corporation of its own shares.[28] Expenses incurred in the purchase by a corporation of its own shares were held not ordinary and necessary expenses of a business, but part of the purchase price.[29] A corporation may deduct as a business expense the difference between the cost of its own shares purchased in the market and the sale price to its employees.[30] In another decision,[31] under about the same circumstances, a gain on shares resold to employees was held income.

The Board of Tax Appeals allowed the deduction of a loss in the *R. J. Reynolds Tobacco Company* case,[32] under the 1928 and 1932 acts, but

was reversed subsequently.[33] Treasury Decision 4430 was issued on May 2, 1934 to amend Regulations 69, 74, and 77 to make the 1934 change retroactive to the earlier years. Following the court decision in the *Reynolds* case, Treasury Decision 4895 was issued on April 17, 1939 to revoke Treasury Decision 4430.

The reversal of T. D. 4430 was not founded on a disallowance of the new rule of inclusion in tax computations of such gains or losses but was merely a refusal to permit the rule to be applied retroactively.

Treasury Decision 4430 was based on several court decisions that inclusion in income depended on the real nature of the transaction.[34] The Board, in a recent decision, has agreed with this type of ruling.[35]

There is substantial agreement among accountants that transactions in a corporation's own shares do not give rise to income but merely cause an adjustment to capital.[36] The opinions expressed by many accountants include the suggestion that charges or credits resulting from such transactions be passed through capital surplus. It is difficult in some cases to determine whether such persons consider gains or losses from transactions in a corporation's own stock as non-operating income or whether they consider such items as non-income items altogether.

The general accounting view has been expressed well by the following selections:

> We would state that the well recognized accounting rule is to credit capital surplus, and not earned surplus available for dividends, with the excess of the par or original issue price, over the cost of capital stock purchased and cancelled. "Profit and loss" arising from the sale of treasury stock is similarly treated: . . . This rule is based upon the principle that it is not the business of a corporation to deal in its own shares.[37]
>
> It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporation profits or in earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.[38]

Robert H. Montgomery is the chief dissenter from the common accounting opinion regarding the treatment of gains and losses on transactions in a corporation's own shares. His opinion is that the use of a corporation's capital results in a profit or loss, whether used to buy merchandise for resale or fixed assets which are resold, or whether used to purchase treasury stock and to resell it.[39]

His opinion is similar to the revised Regulations of 1934, 1936, and 1938. The thing which is of importance is the intention of the corporation and the particular cause for the sale or purchase transaction. Purchases or resales of shares made with the intention of adjusting the capital

equity are properly treated as increases or decreases in capital stock or capital surplus. Transactions entered into for other purposes contribute a gain or loss, just as does any other general operating transaction.

Mr. Montgomery said that in most states treasury stock does not reduce capital, because purchases of treasury stock are required to be made out of surplus. The treasury shares then, according to him, are capital assets and give rise to a capital gain or loss. He added that the exclusion of such gains or losses from income might be a good practical rule, however.[40]

Mr. Montgomery was answered directly by Thomas York, who argued that the purchase was a cancellation of an old contract, the resale was a new contract, and that the resale caused new capital to be contributed to the corporation. Mr. York indicated that there might be some justification for recognizing a profit or loss on the purchase but not on the resale.[41]

Mr. Montgomery's subsequent answer was that the purchaser of treasury shares does not contribute capital, because that was done by the original shareholder. He did indicate that he would be willing to change his view if the shares were actually retired and subsequently another issue of shares was made.[42]

Gross Income—Dividends

DIVIDENDS received are to be included in the gross income of corporations.[43]

Definition of Dividend

THE regulations and acts of 1916-1917 defined dividends as "any distribution made or ordered to be made by a corporation . . . out of its earnings or profits . . . payable to its shareholders whether in cash or in stock of the corporation. . . ."[44] In 1918, property dividends were included specifically to the extent of their fair market value, and it was required that the dividend be paid in order to come within the meaning of the act.[45] The provisions of the years from 1921 to 1934 remained substantially the same as those of 1918, except that stock dividends were no longer included in the above definition.[46]

Prior to 1934, taxable dividends were only those declared out of earnings or profits accumulated since February 28, 1913. In 1936 and 1938,[47] the law was changed in order to make a new class of dividends eligible for the dividends paid credit for purposes of the undistributed net income calculations included in the law of that year.[48] Any distribution made out of current profit, without regard to the accumulated earnings and profits at the time of distribution, was taxable.[49]

Time for Including Dividends Received in Income

The 1917 act stated that dividends received were to be regarded as income to the shareholders for the year of receipt and were to be taxed to the distributee at the rates prescribed by law for the years in which the profits or surplus were accumulated by the corporation.[50]

Dividends declared but unpaid were not taxable[51] in either 1917 or 1918; in the latter year, dividends received were taxed to the recipient at the rate for the year of receipt.[52]

In 1921 and subsequent years, dividends were made subject to tax in the years when they became subject to the unrestricted demands of the stockholders.[53]

Source of Dividends

The regulations of 1916 and 1917 stated that taxable dividends were those paid out of earnings or profits.[54] A dividend was deemed to be paid from earnings, although the corporation resolution directed otherwise.[55] Section 1211 of the 1917 act extended the restriction somewhat by declaring that dividends were to be considered as paid out of the most recently accumulated profits or surplus.[56] No tax was to be levied on dividends paid out of surplus accumulated before March 1, 1913; such amounts were to be treated as reductions in the basis of the stock held in such corporations.

Distributions are conclusively presumed to be made out of earnings or profits to the extent such are accumulated since February 28, 1913.[57]

In 1918, any distribution was deemed to have been out of earnings or profit unless all earnings or profit had been distributed.[58] Any distribution in the first sixty days of the taxable year was deemed to have been made out of earnings or profits of prior years. Distributions in the balance of the year were deemed out of profits or earnings of the taxable year up to the time of the distribution.[59] This latter provision was continued in 1921 but was omitted after December 31, 1921.[60]

Provisions similar to that of Section 201(b) of the 1918 Act were continued in all subsequent years,[61] except for slight modifications in 1936 and 1938.[62] In 1928, 1932, 1934, and again in 1936, the House Ways and Means Committee attempted to have the tax exemption of profits accumulated at February 28, 1913 removed, but in each case the Senate succeeded in restoring the provision.[63] In 1934, the Secretary of the Treasury also indicated that he favored its abolition.[64]

The Ways and Means Committee believed that the law would be simplified and that revenue would be increased if the exemption were removed. The Committee indicated that no hardship would result, since

dividends were not income to shareholders until made available to them, and it cited *Lynch v. Hornby* (247 U.S. 339, 1913 Act) as support.

Liquidating Distributions

In 1918, the law stated that:

Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.[65]

This provision was eliminated in 1921 but was restored in the 1924 and subsequent Acts,[66] because the Treasury Department construed the 1921 act so as to tax liquidating dividends not as capital gains but as ordinary dividends.[67] Despite the provisions of Section 117(a), in 1934 such gains or losses were recognized within the 100% bracket, because it was felt that wealthy stockholders were escaping the surtax on their share of corporation earnings by using profit distributions in the form of liquidating dividends.[68]

There was some slight modification of this last provision in 1936 to permit non-corporate stockholders to be taxed under Section 117(a) under certain conditions.

Dividends Purchased

The Board of Tax Appeals and the courts have held that dividends received are taxable, even though the stock on which the dividends were declared was purchased in anticipation of the dividend and at a price which included the dividend.[69] There is no justification for such a rule as this, except possibly on the grounds of expediency.

Accountants include such items as a mere return of capital, and dividend income is restricted to corporation earnings made during the period the investment is held.[70]

Stock Dividends as Income[71]

Stock dividends were considered income to the amount of their cash value under Section 2(a) of the 1916 Act. The regulations for 1916-1917, however, required that dividends be considered income to the amount of the earnings or profits so distributed.[72] The 1917 amendment of the 1916 act and the act of 1918 followed the regulations and dropped the cash value rule.[73]

Following the decision in 1920 in *Eisner v. Macomber* (252 U.S. 189), the act of 1921[74] specified that stock dividends were not subject to tax.[75] However, if *after* such a distribution, the corporation cancelled or redeemed the dividend shares at a time and in a manner to make the distribution essentially equivalent to a share dividend, the amount re-

ceived in redemption or cancellation was to be treated as a taxable dividend to the extent of the earnings or profits accumulated.[76]

In 1924, Representative Garner of Texas proposed an amendment to tax a share dividend to the extent of its fair market value. He cited the closeness of the five to four decision of the Supreme Court in *Eisner v. Macomber* as justification for another attempt at taxation of share dividends.[77] The proposal was rejected, and the 1924 to 1934 acts,[78] inclusive, remained substantially unmodified, except that a loophole was plugged by the inclusion of cancellations or redemptions *before* as well as after the distribution of such share dividends as justification for taxing such dividends.

The 1936 and 1938 acts and regulations presented a new treatment for stock dividends by recognizing that a non-taxable dividend was only one in which the relative interest of each shareholder was unchanged. In many cases, the decision in *Eisner v. Macomber* had been too broadly applied.[79]

The portions of the statute added in 1936 and 1938[80] were as follows:

(1) A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

The changed attitude and reasoning is expressed clearly by the following portion of the regulations:[81]

The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[82] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus

the old representing the same proportionate interest in the net assets of the corporation as did the old.

This changed viewpoint appears to be an improved treatment for share dividends. The usual argument advanced against including stock dividends is that they give nothing to the shareholder which he did not have before. If a certain share dividend does change the recipient's status, the increased holdings should be taxed.

The trend of decisions regarding the taxability of stock dividends is about the same as that shown in the provisions of the various acts and regulations. A few old decisions interpreting the 1913 Act, which had no specific provision, held such dividends were taxable.[83] Most of the decisions based on the Act from 1916 to 1934 held that stock dividends were not income.[84] More recently, since the passage of the 1936 act, it has been held that where the shareholder has an interest following a stock dividend different from that which he had before the distribution, the share dividend is income.[85] The old rule of tax-exemption still applies when there is no realignment of interests.[86]

The taxability of share dividends at present might be summarized as follows:[87]

1—Common shares to common shareholders, nontaxable.

2—Preferred shares to preferred shareholders, not decided.

3—Common stock to preferred shareholders, taxable if both classes of shares are already outstanding and are not held proportionately by the same shareholders.

4—Preferred shares to common shareholders, taxable under same conditions as #3 above.

5—Preferred shares to common shareholders, nontaxable if no preferred stock was outstanding previously.

6—Common shares to preferred shareholders or vice versa, not decided where both classes are held proportionately by the same shareholders.

The non-inclusion of share dividends in taxable income is based principally upon the decision of the Supreme Court in *Eisner v. Macomber* (252 U. S. 189). The gist of the decision is that in a share dividend, the corporation parts with nothing and the shareholder receives nothing he did not own before. However, a shareholder receives nothing he did not own before in the case of cash dividends.

There is some doubt as to the finality and correctness of the decision in the *Macomber* case. It was decided by a close five to four vote, and the very able Justice Brandeis dissented. Justice Brandeis's dissenting arguments appear to be more compelling than those of the majority opinion. The essence of Justice Brandeis's opinion is given in the following paragraphs.

Dividends declared in *any* securities of a corporation are similar to each other in nature, and there is no important reason to consider bonds

as taxable dividends when received and to exclude shares of capital stock. Proportionate control of the corporation by the shareholders is no more disturbed in the case of a dividend in bonds than it is if the dividend is in shares.

Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved.

Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder after receipt of the stock dividend has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property, for instance, bonds, scrip or preferred stock of the company. [A scrip or bond dividend segregates assets for the shareholder no more than does a stock dividend.] Clearly segregation of assets in a physical sense is not an essential of income. The year's gains of a partner is taxed as income, although there, likewise, no segregation of his share in the gains from that of his partners is had.[88]

The stockholder's interest in the property of the corporation differs, not fundamentally but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporation. No reason appears why Congress, in legislating under levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this court.

The older and more commonly accepted opinion among accountants is that share dividends are not income when received.[89] However, there is some tendency among accountants to question the logic of applying such rule inflexibly under all conditions.[90]

The American Institute of Accountants has granted indirect acceptance, at least, to the idea that share dividends may be income:

Stock dividends if credited to income should be shown separately with a statement of the basis upon which the credit is computed.[91]

Other writers have definitely stated that they favor including share dividends, at least under certain conditions.[92]

If the separate existence of an entity apart from the shareholders is ignored and the "association of stockholders" theory is followed, a corporation is similar to a partnership, and shareholders are similar to partners. Consistency then requires that income of the corporation be considered income to the shareholders as soon as it accumulates to the corporation.[93] Stock dividends are then not income; no dividends would be income under such circumstances; income would have arisen prior to the time of the receipt of the dividend.[94]

Some writers believe stock dividends should be considered income if the separate entity of the corporation is upheld.[95] The income and

accumulated surplus would be considered those of the corporation and not of the shareholders.[96] Under this line of reasoning, the act of distributing *any* dividend would be considered sufficient evidence of separation and realization of income on the part of the shareholders.[97] Those who hold the above opinion criticize those who eliminate stock dividends from income, on the ground that the latter are inconsistent. It is said that on one hand, the latter uphold the entity to the extent of denying that corporation income is shareholder income, and that on the other hand they deny the entity and say that a share dividend gives the shareholder nothing he did not have previously.[98]

Perhaps the best solution to the matter is to consider income of the corporation as income of the shareholder, even before it is distributed. Dividends of all types would then be unimportant in the determination of the shareholder's income, since his income would be considered to have arisen before the issuance of the dividend. The dividend itself, when received, merely would cause an exchange of one type of asset for another. This procedure is frequently followed in the case of subsidiary dividends received by a parent company, subsequent to that parent's having taken up its share of the subsidiary's income.

The taking up of such income before its distribution appears to be valid, whether the entity or association concept of the corporation is held. The shareholder has it within his power to obtain the income in usable form by selling his shares at an appreciated price which includes a proportionate share of the undistributed corporate profits. It must be recognized, of course, that the hazards of and other disturbing factors in the market might cause a different amount to be received than that which exactly included such undistributed profits.

If income accumulated to the corporation is not included in that of the shareholder for tax computations, perhaps the issuance of a share dividend, as well as a dividend of any other type, is an act of separation sufficient to justify the opinion that income to the shareholder has come into being for taxation purposes.

Much simplification and more justice under the income tax law probably would result if the corporation entity were overlooked for tax purposes, as is done with partnerships, and the income were taxed directly to the shareholders as it arose.

It is objected[99] sometimes that recognition by a parent company of accumulated income of a subsidiary before the declaration of a dividend[100] is inconsistent with the usual accounting rule that income of a corporation is not considered income of the shareholders prior to its distribution. No inconsistency exists if we base our ideas on the economic entity. The parent is in control of the subsidiary and forms one economic unit with it. The ordinary stockholder of an ordinary open corporation

is virtually an outsider and does not form a common economic unit with the corporation.

Dividends in stock of another corporation are income to the taxpayer. They are considered a dividend in kind and not a stock dividend.[101] Many decisions agree with this opinion;[102] likewise, it is in conformity with accounting thought. The common view is that dividends paid in bonds of the issuing corporation are income to the shareholders, because ultimately such bonds require a disbursement of assets.[103]

Some accountants feel that the distinction between dividends in shares of a corporation and dividends in other obligations of the corporations is arbitrary and of little importance to the shareholder. In either case, he obtains only an evidence of an amount to be received.[104] Neither has an immediate effect on the assets of the corporation.[105]

Sale of Dividend Shares[106]

From 1918 to 1934, inclusive, there had been specific provision in the regulations for the taxation of gains on subsequent sales of shares received in the form of tax-free stock dividends.[107]

Stock Rights

The Supreme Court has held that stock rights are similar to stock dividends,[108] probably the same rules apply. However, in *Commissioner v. Palmer*,[109] it was held that income from rights arose when they were sold or used and not when received. This ruling conflicts with another decision based on a similar set of conditions, however.[110]

Dividends Received from Domestic Corporations Which Are Subject to Income Tax

The 1913 Act contained no reference to a credit for dividends received from another corporation, but in discussing the 1916 law, Mr. Hull stated that under the 1913 act, such dividends were not exempt from taxation. He said that if a corporation desired to obtain certain benefits from ownership of shares in another corporation, it should not object to being taxed on such dividends.[111]

The Senate Finance Committee proposed the following provision in 1917,[112] but the latter part, commencing with the words "less that proportion . . ." was eliminated by the Conference Committee:

> . . . the income embraced in a return of a corporation shall be credited with the amount received as dividends upon the stock or from the net earnings of any other corporation, joint stock company, or association, or insurance company, which is taxable upon its net income as provided in this title, less that proportion of such amount which the amount received by the distributing corporation . . . from similar sources bears to the entire net income of such distributing corporation. . . .

Credit was to be allowed only to the corporation receiving such divi-

dends directly. The same earnings would be permitted as the basis for only one credit, irrespective of the number of corporations to which, in turn, it might have been paid as dividends.[113]

Section 234(a)(6) of 1918 was followed closely by later acts and was substantially the same as the 1928 provision, which follows:

> In the case of a corporation, the amount received as dividends—(1) from a domestic corporation, or (2) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 119.[114]

In 1932[115] it was specifically stated that dividends received from a domestic corporation must have been received from a corporation subject to income taxation. This is not a significant change, because such a provision had been in all laws previous to 1928 and probably was omitted from that of 1928 through oversight only.

The law was again changed in 1934[116] to eliminate subdivision (2) regarding dividends from foreign corporations. This was evidence of a desire to tighten up the system to obtain more revenue. Further indication of this desire is found in the efforts of Senator Borah to prohibit deduction of dividends received by a holding company from other corporations; although, of course, the primary purpose of this effort was to discourage holding companies.[117]

In an effort to derive more revenue in 1935,[118] a corporation was permitted to deduct only ninety percent of such dividends received. Another reason for the change was that the President suggested the imposition of a small tax on intercorporate dividends to prevent evasion of graduated tax by means of a multiplicity of corporations. The Ways and Means Committee did not think this necessary because of the moderate graduation but permitted it to go by.[119]

In 1936, the Ways and Means Committee[120] favored a full tax on intercorporate dividends, and therefore no credit at all, but the Senate Finance Committee favored the retention of such credit.[121] The result was a compromise and a reduction of the credit from ninety percent to eighty-five percent of the dividends received.[122]

A further limitation was introduced in 1938[123] to the effect that the credit was not to exceed "85 per centum of the adjusted net income."[124] The old limit of eighty-five percent of the amount received remained along with this new limitation.

The gist of the matter is that ten percent in 1935 and fifteen percent in 1936 and in 1938 (subject to the foregoing limitation) of the amount of such dividends is taxable.

Property Sold to a Shareholder by a Corporation for an Amount Substantially Below Its Fair Market Value

ARTICLE 31 of Regulations 69 of 1926 states that:

Where property is sold by a corporation to a shareholder, . . . for an amount substantially less than its fair market value, such shareholder of the corporation . . . shall include in gross income the difference between the amount paid for the property and the amount of its fair market value. In computing the gain or loss from the subsequent sale of such property its cost shall be deemed to be its fair market value at the date of acquisition. This paragraph does not apply to . . . the right to subscribe to . . . stock. . . .

This provision remained unchanged until 1936,[125] and in that year a change was made to the effect that:

In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.[126]

Further slight changes were made in 1938.[127] In the first sentence of Article 31 of 1926, after the place at which the words "fair market value" occur for the first time, is included the restriction "regardless of whether the transfer is in the guise of a sale or exchange." After the end of the first sentence of the 1926 article are also added in 1938 the following words:

to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be.

The inclusion in income of the difference between the amount paid and the amount of the fair market value at the time of the transaction is a recognition of unrealized income. The provision in 1938 limits the inclusion of such amounts to the cases in which they are definitely in the nature of compensation or distribution of income.

Income Constructively Received

RECOGNITION of the separate entities of different taxpayers has been granted in the Regulations of 1918 to 1938, inclusive.[128]

Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. . . .

Apparently, in order to have income, one must have control over it or over the enterprise or person from whom it is to be derived.

If the income is "available" and the corpus or source from which it arises is within the control of some one it does no violence to our sense of justice to apply the rule of constructive income.[129]

Both the Board of Tax Appeals and the court have upheld the rule that an amount credited on the books of a corporation to a shareholder is constructively received in the year in which credited.[130]

Consolidated Income

THERE has been widespread agreement among accountants[131] that consolidated returns are necessary under certain conditions in order to express the income of an economic group. This opinion is recognition that the legal entity is not the proper entity for accounting purposes, but that a wider economic entity must be considered. The reasons usually given to justify the use of consolidated statements are that they are more correct, simpler, ordinary business procedure, and economical of administration on the part of the income tax department.[132]

At present, the position of consolidated statements in American finance is beyond question,[133] but there is some disagreement on to whom the credit should go for initiating and developing such statements. Sometimes the Federal income tax provisions are cited as the primary cause, on the ground that accounting literature existing at the time of the creation of the Federal income tax treated such statements in a very elementary fashion.[134] However, the weight of opinion seems to be that the income tax law merely recognized an existing accounting methodology.[135] The American Institute of Accountants, in its several audit pamphlets, has been slow and cautious in its recognition of consolidated statements.[136]

About the time that the use of consolidated statements was being restricted for income tax purposes, the Securities Act of 1933 and the Securities and Exchange Act of 1934 granted them additional consideration.[137]

Corporation statements should be consolidated only if certain conditions are present. The minimum for a controlling interest should be fifty percent of the shares.[138] The companies to be consolidated must be related in operations[139] and must be domestic companies.[140] This latter requirement, perhaps, is a matter of expediency only.

. . . the inclusion of a subsidiary in the consolidation is a recognition of the existence of a business or economic unit composed of several legal units.[141]

The purpose underlying the use of consolidated returns was[142] concisely expressed by Article 631 of the Regulations of 1918.

The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though

the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. . . . Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise, opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group.

Consolidated returns were forbidden by the Regulations of 1916, although affiliated corporations might have been, in reality, little more than branches of a business enterprise. For income tax purposes, every corporation was considered a separate and distinct entity.[143]

Prior to 1918, the acts did not definitely permit consolidated returns; however, the regulations for the 1917 act provided for such combined reporting.[144]

Consolidated returns were made mandatory in 1918,[145] because it was felt that the year's trial under the regulations of 1917 was a distinct success.

So far as its immediate effect is concerned consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasion which can not be successfully blocked in any other way. While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government.[146]

In 1921,[147] the regulations under the 1917 act were validated by specific provision in the 1921 act.[148] To justify consolidation under Section 1331 of the 1921 act, one corporation had to be a subsidiary of the other, and to be engaged in the same or a closely related business.[149]

An option was given in the use of consolidated returns under the act of 1921, because it was felt that such consolidated returns might be so complex that some corporations might not desire to use them.[150] For taxable years starting on or after January 1, 1922, affiliated corporations were given the option of separate or consolidated returns. The basis chosen was to be adhered to thereafter.[151] For taxable years before January 1, 1922, mandatory returns were specified.[152] There was no further change in 1924 and 1926.[153]

The provisions for the taxable year of 1928 remained substantially

unchanged,[154] but the 1928 act contained a major change for 1929 and thereafter. Consolidated returns were no longer to be permitted for mere affiliated companies but were restricted to parent-subsidiary groups.[155] This provision was in conformity with the suggestion of the Joint Committee on Internal Revenue Taxation.[156]

The Ways and Means Committee recommended the abolition, for 1929 and thereafter, of consolidated returns for affiliated companies on the grounds that the problems of interpretation and administration of the existing law were so very difficult. The Committee proposed that in the absence of consolidated returns, a loss of one affiliated company be permitted to be offset against a gain of another or others in the group, but the proposal was rejected.[157]

In spite of objections,[158] the above provisions were passed. The privilege given to parent-subsidiary groups of filing consolidated returns was a restricted one. If a group filed a consolidated return, all of its members were to be included in that return. Apparently each case was to be decided under its peculiar circumstances.

The Commissioner was given the right to prescribe regulations regarding (1) the extent to which gain or loss was to be recognized on sales or retirements of stock issued by some of the group to others, (2) the basis for property acquired from an affiliated company during the period of affiliation, (3) the manner of handling losses before or after affiliation of any member in the consolidated return, and (4) the extent and manner for recognizing gains or losses upon the withdrawal of one or more members by reason of transactions occurring during the affiliated period.[159]

The attitude of the Senate Finance Committee[160] is worth reporting at length. The Committee restored the consolidated returns provision eliminated by the House, but the Conference Committee again caused the elimination of the provision.

After the enactment of the act of 1917, a committee composed of members of the House Ways and Means Committee and of the Senate Finance Committee and of experts, engaged themselves in preparing regulations for that act. Their careful and non-partisan consideration led to the authorization by the Treasury of consolidated returns by corporations which by reason of common ownership were affiliated. Congress adopted these regulations and wrote them into the 1918 Act and retained them substantially unchanged up to 1928.[161]

The Advisory Committee of the Joint Committee on Internal Revenue Taxation concluded that simplification of the law required the elimination of consolidated return provisions.

It should be emphasized that this conclusion was reached not upon the ground that consolidated returns were unsound, that additional revenues would

be received by the elimination of the consolidated return provision, but solely upon the ground that the administration of the law would be simplified. Accordingly, they proposed a provision which was designed to retain the advantages of consolidated returns and eliminate the administrative disadvantages. This provision was to become effective for the taxable year 1929 and the present law was to be retained for 1927 and 1928.[162]

The House struck out the substitute for the consolidated returns provision and thus required corporations to be taxed individually, in the expectation of greater revenue.[163]

Your committee has considered the matter very carefully and is convinced that the elimination of the consolidated returns provision will not produce any increase in revenue, will not impose any greater taxes on corporations, and will in all probability permit of tax avoidance to such an extent as to decrease revenues.[164]

The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. . . . To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.[165]

The provision embodies the business man's conception of a practical state of facts. Your Committee believes that rather than departing from business practices and standards our revenue laws should be brought nearer to a recognition of them.[166]

There was no substantial change in the consolidated returns provisions in 1932, and such returns were still permitted to parent-subsidiary groups only.[167] However, for 1932 and 1933 an additional tax rate of three-quarters of one percent was added to the tax on income, computed in a consolidated return. The Senate Finance Committee favored eliminating altogether the proposed additional tax rate of one and one-half percent suggested by the House but succeeded only in getting it cut in half.[168] A two percent additional tax rate was added in 1934 but was omitted in 1936 and 1938.

In 1932, many suggestions were made in the House that the remnants of the consolidated-returns provisions be eliminated. The arguments advanced were chiefly social in nature; it was said that large consolidated groups were encouraged, to the detriment of smaller enterprisers.[169] Complete elimination was not accomplished, but the above-mentioned discriminatory rates were introduced.

The 1934 act[170] restricted the use of consolidated returns to railroad and railroad holding companies. They were given preferred treatment because of their precarious financial condition and their necessity for incorporating in many states.[171]

Consolidated returns were again restricted to railroad and railroad holding companies in the 1936 and 1938 acts; street, suburban, and interurban electric railway systems were specifically included.[172]

As late as 1934, the Ways and Means Committee decided it was desirable from an administrative point of view to retain consolidated returns provisions, although it reversed the conclusions of the Ways and Means Subcommittee in coming to the above conclusion.[173]

Another provision was inserted into the law to supplement the consolidated-returns provisions.

> In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.[174]

This provision is similar to Section 240 (f) of 1926 and has been broadened to afford adequate protection to the Government because of the elimination of the consolidated-return provision of the 1926 act. It has been contended that Section 240 (f) of the 1926 act permitted what was in effect the filing of a consolidated return by two or more businesses even though they were not affiliated within the meaning of the law. Section 45 prevents this erroneous interpretation by eliminating the phrase "consolidate the accounts."[175]

The purpose of this section has been explained further by the Regulations:[176]

> The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income . . . of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income . . . of each of the controlled taxpayers. If, however, this has not been done, and the taxable net income is thereby understated, the statute contemplates that the Commissioner shall intervene. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. . . . It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.

Chapter Summary

In a great many ways, the Income Tax Provisions examined in this chapter agree closely with accounting procedures.

The entire proceeds of the original issuance of shares, subsequent

assessments upon the shareholders, and forgiveness of debt or other donations made by shareholders are considered capital contributions and without effect upon the income of either the corporation or of the shareholder. This is the accounting viewpoint and always has been that of the Federal income tax.

Liquidating dividends are considered payments in exchange for shares and subject to the rules regarding gains or losses on sales or exchanges. A provision such as this appeared in 1918, was omitted in 1921, and was restored in 1924. It is at present a part of the law, and is in conformity with accounting methodology.

Non-taxable share dividends give rise to gain or loss on subsequent disposition, according to the Federal income tax provisions in all of the years from 1918 to 1934, inclusive.

In accounting for the income of an enterprise, three possible centers might be chosen about which to gather the calculations: association of shareholders, legal entity, or economic entity. The last appears to be best and is used as the basis, in this paper, for judging detailed income tax and accounting provisions for income determination. Control is essential for an economic entity. In the absence of control, an objective event is usually required to mark the existence or point for measuring income.

In most cases, the legal and the economic entity coincide, and support of one is support of the other. In other cases, the legal entity is ignored, rightly, and only the economic entity is upheld.

In 1916 and 1917, gains or losses on its own shares reacquired by a corporation were considered taxable income. From 1918 to 1932, inclusive, such gains or losses were considered capital changes only. A more reasonable rule has appeared since the 1934 act. The gist of this rule is that a gain or loss is realized if the transaction is not intended to be a capital adjustment. To summarize, for the years of 1918 through 1932, the entity was ignored; in the other years, the separate entity was upheld. The opinions of accountants, the courts, and the Board, and the Regulations in this matter have shown about the same trend toward recognition of such gains or losses and the upholding of the separate entity.

The separate entity has been supported by the law throughout its modern existence in the matter of dividends in general. In 1917 and 1918, dividends were considered income upon receipt. The law was changed but the entity was still upheld in the years of 1921 through 1928, years in which the rule was that income on dividends was realized when they were made available without restriction to the shareholders.

The Board of Tax Appeals and the courts have held that dividends purchased are capital contributions and that subsequent receipts of dividends are income to the entire extent. This rule is based on ex-

pediency, or perhaps on an exaggerated idea of the corporate entity. Needless to say, accountants disagree with this rule and feel that it results in taxation of capital.

With the exception of a few years, the income tax has provided that earnings or profits accumulated are the proper source of dividends. In 1918, 1921, 1936, and 1938, distributions were considered taxable dividends if paid out of earnings of the current year (latter portion of the year in 1918 and 1921) without regard to the existence of a deficit at the start of the year. The intention in 1936 and 1938 was to provide a larger amount of taxable dividends for purposes of computing a credit for the undistributed profits tax. These provisions have been opposed by accountants on the ground that liquidation dividends are being taxed.

Up to the *Eisner* case in 1920, stock dividends were considered taxable income. This treatment, perhaps, may be proper under an entity rule. From 1921 to 1934, inclusive, such dividends were not considered income. There appears to be some inconsistency in reasoning underlying this rule. First the entity is upheld by a denial that profits accumulated to a corporation are also accumulated to the shareholders. Then the entity theory is torn down by a denial that the dividend is an act of separation marking the point at which income may be said to have come into existence for the recipient of the share dividend.

A more reasonable rule has been established in 1936 and 1938 to the effect that taxable income results from a share dividend based on accumulated corporate income provided the dividend works a change in the proportionate interests of the various shareholders. This new rule is a partial recognition of the entity conception and could be improved if all share dividends were considered income when irrevocably made available to the shareholders. Perhaps the best treatment would be to treat *all* dividends alike and to consider that income to shareholders comes into existence when income is acquired by the corporation and not when the distribution takes place. The trend of court decisions has paralleled the change in the acts and regulations. Much the same comment might be made regarding accounting opinion, although there is less willingness among accountants to agree that share dividends are a proper base for income taxation.

In so far as parent-subsidiary groups are not under consideration, the credit allowed one corporation for dividends received from another corporation subject to the Federal income tax breaks down the entity concept. In 1913, such intercorporate dividends were fully taxed. From 1917 to 1934, inclusive, they were fully tax-free. In 1933, they were taxed to the extent of ten percent of the amount received; a ninety percent credit was allowed. In 1936 and 1938, only an eighty-five percent credit was

permitted. If intercorporate dividends are in question within a holding company group, such a credit would override, properly, the legal entity idea but would not violate the more correct economic entity conception.

The corporate entity theory is cast down by the income tax provisions which stipulate that income is obtained by a shareholder if property is sold to him by a corporation for an amount substantially below the fair market value. However, a situation such as this arises usually only in the case of closely controlled corporations, in which the entity concept is of less validity than in the case of the ordinary open corporation. From 1926 through 1936, the difference between sales price and fair market value was considered taxable income. The 1938 provision was slightly improved, in that income in such cases is taxed only if the transaction is equivalent to a distribution of earnings or to compensation for services.

The entity theory is not violated by the constructive-receipt provisions which have appeared in the law since 1918.

Consolidated returns ignore the artificiality of the legal entity of corporations and stay within and recognize the economic entity of a larger economic enterprise in appropriate cases. Such returns were forbidden in 1916, were optional in 1917, and mandatory in 1918. The 1921 Act continued the mandatory rule for returns for taxable years prior to January 1, 1922, but made returns for years on or after that date optional. The option was granted, because it was felt that some groups might consider the preparation of such returns too burdensome.

There was no important change from 1924 to 1928, inclusive, but for the year of 1929, consolidated returns were restricted to parent-subsidiary groups. They were further restricted to railroads and railroad holding companies in 1934, 1936, and 1938. In 1932 and 1933, an extra rate of tax of three-quarters of one percent was charged for their use. The discriminatory rate was raised to two percent in 1934 but was omitted in 1936 and 1938.

In order to protect the government against manipulation of income calculations by affiliated companies following the removal of consolidated returns provision, the law has given permission in the years since 1928 to the Commissioner, to overlook the artificial legal entities and to adjust the income figures to show true income. This is rather paradoxical. The economic entity is recognized for reapportionments of gross incomes and deductions but is ignored in assessing the tax.

Accountants, tax experts, committees of Congress, and business men have agreed almost unanimously that consolidated returns are necessary and desirable, but for expedient reasons, they have been disallowed for general use since 1929.

If the entity theory is upheld, both shareholders and other capital

contributors should be considered similar in nature and the rewards for their services inherently similar, although they are computed differently and are of varying degrees of certainty. It follows, then, that interest and dividends should be treated alike, as expenses of the entity.[177]

To summarize briefly the matter of the accounting entity, it must be said that the predominant characteristics are inconsistency and expediency. The two entity theories and the association concept are used unsystematically both by accountants and in the Federal income tax.

CHAPTER VII

GROSS INCOME ITEMS

BOTH GROSS INCOME AND DEDUCTIONS therefrom must be considered in computing net income. In regard to both gross incomes and deductions, two principal things must be given consideration, namely: (1) the nature of the items themselves, and (2) the time for taking them into consideration. We must not only know what things are to be matched but also when to match them.

The time for including gross incomes in our net income calculation has already been discussed;[1] therefore, this chapter is limited to a discussion of the types of things which are considered a part of gross income. The nature[2] and the time[3] for taking deductions are discussed elsewhere.

In the 1913 Regulations, most of the emphasis was placed on deductions, but the 1916 and 1917 Regulations devoted more attention to gross income items.

> . . . the normal tax . . . shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding . . . year to every corporation, . . . organized in the United States; no matter how created or organized; . . .[4]

The emphasis is on income from *all* sources. Any exceptions to this must be stated specifically in the statutes. Substantially the same provision has been included in the acts of all of the years from 1913 to 1938, inclusive.[5]

For Federal income tax purposes, gross income items are divided into two general classes: taxable and non-taxable income.

Items Included in Taxable Gross Income

REGARDING gross income, the Regulations of 1913, 1916, and 1917 stated:[6]

> It will be noticed from these definitions that the gross income embraces not only the operating revenues, but also income, gains, or profits from all other sources, such as rentals, royalties, interest, and dividends from stock owned in other corporations,[7] and appreciation in the values of assets, if taken up on the books of acount as gain; also profits made from the sale of assets, investments, etc.

Again, as in many other places in the law, emphasis is placed on the inclusion of all income, even that which is extraordinary or non-recurring in nature.[8] The Regulations of 1913, 1916, and 1917 carried this idea so far as to include unrealized appreciation of assets as income, provided it had been placed on the books.[9]

In general, the following items are included in taxable gross income:

business income; profits from sales and transactions in property; interest; rent; dividends; gains, profits, and income derived from any source whatever.[10]

In 1918,[11] the amount of tax paid by the obligor of bonds with a tax-free covenant was considered additional income to the bondholder, although the amount paid was allowed as a credit against the tax.

In the 1926 and succeeding acts,[12]

The amount of income tax paid for a bondholder by the obligor pursuant to a so-called taxfree covenant in its bonds shall not be included in the gross income of the bondholder. . . . The amount of the tax so paid may nevertheless be claimed as a credit against the total amount of tax due. . . .[13]

In the regulations, income has been defined as gain derived from capital, labor, or both combined, provided it be understood to include profit gained through a sale or conversion of capital assets.[14]

Gross Income From Business

In the 1918 and subsequent regulations,[15] it has been provided that

In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold,[16] plus any income from investments and from incidental or outside operations or sources.[17]

This provision appears to be satisfactory from an accounting point of view. Again, the concept of all-inclusive income is emphasized.

Income From Leased Property

Income from leased property is properly regarded under the income tax law as an element of taxable income. As early as 1918, the regulations contained recognition of the proper inclusion of such an item, and substantially the same provision has been included ever since.[18]

Article 546 of Regulations 45 of 1918 stated:

Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest and dividend payments received as from lessor and as such shall be accounted for in their returns.

There is little room for disagreement with the above provision, which has existed all of these past years.

Dividends and Purchases of Shares Between Dividend Dates

THE following income tax rule appeared in the regulations of 1926.[19]

In the case of stock sold between dividend dates, the entire amount of the dividend is income to the vendee and must be reported in his gross income when the dividend becomes due and payable. The amount advanced by the vendee to the vendor in contemplation of the next dividend payment is an investment of capital and may not be claimed as a deduction from gross income.[20]

In 1936, the matter was explained a bit more completely:

The fact that a dividend is declared shortly after the sale of corporate stock and the sale price is influenced by the expectation of the payment of a dividend, does not make such dividend when paid taxable to the vendor as a dividend.

It is difficult to see any theoretical justification for not taxing the vendor on dividends sold by him. Income on securities is, roughly speaking, a reward for money invested. Although it is generally felt that dividends do not accrue, it seems that in a case in which the transfer price included an adjustment for such dividends the amount so adjusted should be income to the vendor only and a reduction of income for the vendee. There would be no great difficulty of measurement in such cases to complicate administration of the tax.

Taxable-Interest in General

EVEN as early as the 1894 act, interest income, in general, has been taxed; this is true, of course, with the exception of a few types of exempt interest. The taxation of interest has been stipulated in all of the income tax laws, including the latest.[21]

Interest on the proceeds of life insurance policies is taxable,[22] although the proceeds may be exempt.

Interest on Obligations of the United States and Possessions[23]

THE general rule is that interest on obligations of the United States and its possessions is tax-exempt.[24] However, this generalization must be modified for particular items.

If the obligations are issued after September 1, 1917, the interest is exempt only if and to the extent provided in the Acts authorizing the issuance of the obligations.[25] This group includes Treasury certificates of indebtedness, war savings certificates, Liberty bonds, and Victory notes. First Liberty Loan 3½% bonds were totally exempt, however. In 1921,

this total exemption was extended to Victory Liberty Loan 3¾ convertible notes.[26]

In 1928,[27] slight modifications were made, which were of primary interest to individuals, to the effect that "The interest on all these obligations is exempt from the normal income tax." Liberty Loan 4% and 4¼% bonds, Treasury bonds, Treasury certificates of indebtedness, Treasury savings certificates, and Treasury notes were exempted from all but the surtax, and were exempt from the surtax to the extent of interest on the amount of $5,000 of the face of such obligations.

The next important modification took place in 1934,[28] and was caused by the appearance of many of the "New Deal" government agencies and corporations. It was provided that obligations of a corporation organized under act of Congress, if such corporation is an instrumentality of the United States, are generally exempt from tax. The interest on such obligations was declared exempt to the amount stated in the acts authorizing their issuance. This provision has remained unchanged in both the 1936 and the 1938 Acts.[29]

Interest on Obligations of a State or Subdivision Thereof and of Possessions of the United States

SECTION B of 1913 required:

> That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivisions thereof, and upon the obligations of the United States or its possessions; . . .[30]

The exemption of interest upon such obligations has continued into the present law,[31] even though the exemption granted to employees of such jurisdictions has been discontinued in the 1939 Public Salary Act.

There is less reason to retain this provision than there is to eliminate it. Evidence that its continued existence can be traced to inertia and to expediency is found in the various discussions Congress has held regarding the matter.

In 1913, Mr. Hull[32] indicated that since the Supreme Court had frequently held that states may not tax instrumentalities of the Federal Government, and vice versa, Congress did not wish to raise constitutional questions or to antagonize the states by taxing such income. Mr. Bartlett added that people were promised such tax exemption in case of war.

In 1918, some effort was made to tax the income from such securities if newly issued. In spite of its doubt as to the constitutionality, the Ways and Means Committee favored such taxation, at least in time of war, so that the holders of such securities might share the burdens of war.[33] However, the Senate Finance Committee struck out the suggestion of the Ways and Means Committee because:

> . . . apart from the constitutional question, it seemed unwise for Congress to attempt to impose the tax upon the obligations of states and municipalities as long as the states are not free to tax in a similar manner the obligations of the United States.[34]

A proposed amendment to abolish such tax exemption was introduced in 1922 and passed the House on January 23, 1923, but was never reported out of the Senate Committee to which it was referred.

Running through all of the Congressional discussion appears to be some doubt as to the constitutionality of taxation of income from obligations of states and subdivisions thereof. There does not appear to be any steadfast conviction that such a tax is unconstitutional; rather, there is evident merely a desire to side-step the question by making such income tax-exempt.

Whether or not the taxation of income from securities issued by states or their subdivisions is contrary to the Constitution is not a settled matter. There is an imposing array of support for the thesis of unconstitutionality,[35] but the group which supports the idea that no violation of constitutional provisions would result from such taxation is more recent and probably more impressive and persuasive.[36]

Denial of the constitutionality of Federal taxation of income from securities of states and subdivisions thereof is founded on the decision in *McColloch v. Maryland*,[37] decided in 1819. The oft-quoted statement was made that cross-taxation was undesirable because "the power to tax is the power to destroy." The citation of this case in support of immunity of income from one class of jurisdictions from tax by another class is not accurate. The tax at issue in *McColloch v. Maryland* was a discriminatory tax designed to drive the Bank of the United States out of existence; it was not a general tax applied alike to all, as is true of a tax on the income from such obligations. A general tax on all to obtain revenue is not a tax levied with intent to destroy.[38] Mr. Justice Holmes said, in 1927: "The power to tax is not the power to destroy while this court sits."[39]

> It may be urged, further, that even if the exemption of state securities from a federal income tax were of real advantage to the states, there seems to be no reason why the federal government should confer upon them this advantage. The constitutional inhibition, if it means anything, means only that the national government shall not discriminate against the states by injuring their power to borrow. It does not mean that the national government should discriminate in favor of the states by enhancing their power to borrow.[40]

In 1930, the Supreme Court held that profit from the sale of state and municipal bonds was taxable by the United States.[41] In the 1939 Public Salary Act, taxes have been imposed on the salaries of state and municipal employees. Both of these types of income are closely akin to income derived directly from state or municipal bonds.

A detailed discussion of constitutionality is outside of the sphere of this study. Let it suffice to say that perhaps there is no serious constitutional objection to the taxation of such items.

Aside from the constitutional question, the financial desirability or undesirability of Federal taxation of income from obligations of states and subdivisions must be given consideration.

The results of a study made in 1926[42] indicated that tax-exempt securities might not be the great evil they have often been held to be. The conclusions reached were:

1. Not much Federal tax revenue is lost because of investments in tax exempt securities.
2. The amount saved by states and municipalities on account of such exemptions is about as large as the amount lost by the Federal Government.
3. Industry and trade are not seriously handicapped by the competition of tax-exempt bonds for available funds.
4. Tax-exemption does not cause state and municipal extravagance.
5. Other arguments for the abolition of tax-exempt securities are unsound or unimportant.
6. Most of the arguments in favor of tax-exemption are unsound; but in view of the extent to which such exemption subsidizes good roads, schools, etc., the abolition of such exemptions would probably do more harm than good.

In direct contradiction to the conclusions drawn from the above study, the general feeling is that tax-exempt securities are undesirable in their effect on industry and on government finances.[43] The tendency in income taxation, the world over, is toward taxation, not exemption, of income from government securities.[44]

As far as Federal taxation of income from securities of states and subdivisions is concerned, there appears to be no very valid constitutional objection. Likewise, there appears to be no financial benefit to be gained from the exemption from the income tax of income from such securities.

The exclusion of income from *any* government security is a divergence from business and accounting methods for income calculation which is not adequately justified.

Dividends and Interest From Agricultural Agencies

In 1918 and 1921,[45] dividends and interest from Federal land banks and national farm loan associations were declared exempt. This exemption was extended in the Acts of 1924 through 1932[46] to include interest and dividends from Federal Intermediate Credit banks.

The exemptions found in the earlier regulations were continued in 1934, but specific limitation was made as to certain other farm agencies. In 1934,[47] dividends on the stock of the central bank for cooperatives, production credit corporations, production credit associations, and banks

for cooperatives organized under the Farm Credit Act of 1933 were stated to be income taxable to the recipients as long as these organizations are exempt from the Federal income tax on the grounds that some of their stock is owned by the United States.

There has been no change in 1936 and 1938;[48] except that in the latter year, dividends on share accounts of Federal savings and loan associations were exempted from the normal tax.

Interest on Postal Savings Accounts

UNDER the 1918 Regulations,[49] interest received from postal savings deposits was fully exempt if the deposit was made before September 1, 1917, but was taxable if the deposit was made after that date.

Interest on postal savings accounts has been held tax-exempt in full according to the Regulations of all years subsequent to 1918.[50]

Dividends Received on the Stock of Federal Reserve Banks

DIVIDENDS received on the stock of Federal Reserve Banks are not subject to tax, but dividends received from member banks are taxable. A provision such as this has been a part of our Regulations since 1918.[51]

Miscellaneous

A NUMBER of rules and decisions regarding miscellaneous specific income items have been handed down which are in substantial agreement with accounting methods for income calculation.

The amount of any compensation received for damages in excess of the amount necessary to make good the damages was considered income for the year in which received. If the entire or estimated amount of damages has been charged off previously, the entire amount received as compensation shall be returned as income.[52] A slight deviation from accurate matching is thus introduced into the income calculation but perhaps can be justified on the grounds of expediency.

Royalties from patents are income and should be so reported.[53]

Mere contributions of capital or the return of capital,[54] and gifts[55] are not considered taxable income.

Chapter Summary

THE outstanding impression left by a study of the various items, either taxable or tax-exempt according to their nature, is that there has been relatively little change in the income tax in the years between 1913 and the present.

In all of the years, it has been the general rule that all types of incomes are taxable. Certain exceptions have been mentioned specifically, however.

From 1918 to 1938, inclusive, the following items have been mentioned as fully subject to tax: business income, income from leased property, and dividends received from member banks of the Federal Reserve System.

Dividends on capital stock included and considered in the transfer price of shares of stock have been considered income to the vendee of the shares when the dividends are received, according to the provisions of the years 1926 to 1938, inclusive. This provision is contrary to correct income determination.

In general, the items included in income are not open to much objection; the law has been consistent and of long-standing in its advocacy of correct inclusions.

Much objection can be raised regarding the items excluded from taxable income, however. The inclusions generally have been made on the grounds of expediency. The chief item of offense in this respect is interest income. Ever since 1913, the general rule has been that all interest, in general, is taxable. However, certain tax-exempt items have been specified since the earliest years of the tax.

In 1913, it was stated that interest received on obligations of states, their subdivisions, and possessions of the United States were exempt In 1917, the general rule was established that interest on the obligations of the United States or its possessions were tax-free. If they were issued after September 1, 1917, the interest is exempt only to the extent provided in the acts authorizing the issuance of the obligations. This same rule was extended in 1934 to include the many new Government agencies and corporations introduced as instrumentalities of the Federal Government.

In 1918, agricultural interests were given a subsidy by tax-exemption granted to the interest and dividends received from certain agricultural agencies.

Since 1921, interest received on postal savings accounts has been fully exempt. Prior to that time, interest on such accounts was taxable if the deposit was made after September 1, 1917.

In 1918, the tax paid by the obligor of tax-free covenant bonds was included as income of the bondholder. This was as it should be; but in 1926, it was removed from the taxable class. In all of the years, the amount of the tax has been allowed as a credit against the income tax computed.

Satisfactory treatment has been accorded interest received on life insurance proceeds. Since 1926, such interest has been taxed, although the proceeds of the policy may be tax-exempt.

The interest provisions in the preceding paragraphs have been in force, in all cases, from the dates given to the present time.

Certain other items of gross income are discussed elsewhere in this book. In Chapter V, Non-Recurring Items, the following are discussed: capital gains, disposal of installment obligations, real property sold in lots, the sale of goodwill, the sale of patents and copyrights, the sale of mines and oil and gas wells, short sales, the forgiveness of debts (from the point of view of the debtor), the proceeds from life insurance policies, the recovery of bad debts, leasehold improvements made by the lessee (from the point of view of the lessor), and gifts. Items of income to corporations as stockholders of other corporations are discussed in Chapter VI, The Accounting Entity. Amortization of premiums on bonds issued and of discount on bonds purchased are treated in Chapter IX, Amortization.

CHAPTER VIII

DEDUCTION ITEMS

SHALL THE INCOME TAX be a tax on gross or net income? After all of the advantages and disadvantages of each are considered, one must choose the net income tax. The chief advantages of a gross tax are its ease of computation and administration with a minimum of evasion. The disadvantages are that proportionate ability to pay is not considered; recovery of cost and deductions are given no consideration.

Income is a net concept; it connotes increased wealth which will be at the disposal of the owner for consumption purposes at some time or other without a reduction in the beginning capital store.

> It is an axiom of economics that the maintenance of invested capital is a prerequisite to the showing of profit, that a business enterprise must deduct from its gross income for any given period of time the amount of all assets consumed and all values expired in the earning of income before a figure of net income or net loss for the period can be determined.[1]

The common idea of income held by accountants and economists[2] is net in nature, but the courts and the Board of Tax Appeals are inconsistent; sometimes they observe the net concept and sometimes they ignore it.

In 1913, 1916, and 1917, the statute itself specified:

> That the normal tax . . . shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, . . . organized in the United States, no matter how created or organized.[3]

Similar provisions regarding the use of net income as the basis for the income tax on corporations have been included in the Acts of each of the following years.[4] Most of the objections raised[5] against the income base used for taxation would be groundless if the tax concept were truly a net concept as is stated in the acts themselves. The law goes on to define what it means by net income, but unfortunately its definition does not agree at all with the economic and accounting idea of net.

That the income tax computation of net income is intended to be different from accounting methods is clearly evident in the following portion of the 1913 regulations.

> Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.[6]

This statement falls far short of being helpful. In addition to its poor

treatment of deductions, it is open to objection in so far as its implications regarding gross income are concerned. The matter of gross income, however, is not under discussion at this point.

The regulations of 1916 and 1917 go on to say that:

> The net income upon which the tax is levied is that portion of the gross income received from all sources (except . . .) which remains after all authorized deductions have been taken into account.[7]

In brief, statutory net income is composed of all items of gross income with the exception of some which are tax-free, less all deductions which are permitted by law.[8-9]

The Supreme Court has upheld this limited net income concept of the income tax law in several cases, and has held that Congress may tax gross income by allowing only such deductions as it wishes.[10]

All asset outflows are properly deductible from gross income inflows to arrive at net income for the entire life of an enterprise. Some of these outflows are easily matched with inflows or are easily determined to represent expired assets, but others occur infrequently and represent large expirations of assets which are not clearly associated with particular inflows. The former type is known as expenses and operating losses; the latter, as losses or extraneous losses. They are really basically similar in nature.

The ideal situation requires accrual, i.e., placing of all losses and expenses within their proper accounting period.[11]

> Let it be said again that there is no intention to suggest extreme and impractical lines of analysis, but the thesis that all costs are on a parity as far as recovery through revenue is concerned and that, therefore, any legitimate cost may be deferred and included in cost inventories provided a reasonable method of working this out may be developed seems to be thoroughly valid.[12]

We can do this for operating expenses and for certain types of recurring or predictable losses, such as those for bad debts, future maintenance obligations, fire losses (in some cases), and others which are quite closely related to ordinary business operations.[13]

Recurring or predictable losses of this nature are often justified as risk costs of operation, but it might be more proper to say that all losses should be deducted, and that some are not so deducted (as are the so-called risk costs) merely because accurate or adequate measurement for deduction purposes has not been or can not be made. The difference lies not in the field of theory but in the realm of practical expediency. The above reasoning is different from that inherent in a risk cost concept.[14] The justification for deductions in the nature of predictable losses is not found in an anticipation of future risk losses but rather in the fact that all losses and expenses are properly deductible from gross income on a matched basis.

Future losses from sale or disposition of fixed assets and securities are so unpredictable that adequate measurement for spreading such losses over the holding period of the assets is not feasible.[15] The unpredictability and immeasurability in most cases of future losses associated with inventories also should require that reserves for market fluctuations be omitted from income calculations. However, many practicing accountants justify inventory reserves on the basis of conservatism in providing for the risk cost of carrying goods available for sale.

Payments made by a taxpayer on behalf of another are not deductible on the taxpayer's return,[16] although perhaps they might be deductible as bad debts if there was a promise made of reimbursement to the taxpayer, which promise was not fulfilled. This is a perfectly reasonable rule, in as much as tax returns are made out for individual business entities.[17]

Deductions are made on the basis of present knowledge, and the Commissioner may not disallow such merely because of possible future recoveries.

Since the first Act, in 1913, the law has stated that ordinary and necessary business expenses may be deducted.[18]

> Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, . . . received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property; . . . [19]

This provision quite definitely is limited to the more recurrent operating items. Ordinary and necessary expenses incurred in the operation and maintenance of the business and properties of a corporation are deductible only if they are usual and essential in the case of similar corporations and do not include nonessential expenditures.[20]

The nature of business expenses is explained in the 1918 regulations and in its successors and predecessors.[21]

> Business expenses, . . . include all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses, except such items as are treated in articles 121 to 268. Among the items to be treated as business expenses are material, labor, supplies, and repairs . . . include . . . goods bought for resale. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, advertising and other selling expenses, together with insurance policies against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. But . . . taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source. . . .[22]

The regulations of later years add to this list of examples certain traveling expenses, commissions, and automobile expenses.

The above provision regarding business expenses is satisfactory if not limited strictly to the principal business activity. Until recently it was considered broad enough to cover all expenses incurred in producing taxable income even though not strictly in trade or business, but later rulings have been based on a narrower interpretation.

For purposes of discussion, the deductions from gross income made to arrive at net income will be broken up into three classifications: (1) those deductible in full for income tax purposes, (2) those partially deductible, and (3) those entirely disallowed.

Deductible in Full

Repairs

Ordinary repairs made for maintenance have always been deductible in full under the Federal income tax law.[23]

> Incidental repairs which neither add to the value of the property nor appreciably prolong its life, but keep it in an operating condition, may be deducted as expenses.[24]
>
> . . . , provided that the plant or property account is not increased by the amount of such expenditures. Such repairs to the extent that they arrest deterioration, should have the effect to reduce the depreciation charge otherwise deductible.[25]

In 1918 the following words were added:

> Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property should be charged against the depreciation reserve.

The Board of Tax Appeals has frequently upheld the right to deduct repairs;[26] most cases involving repairs involve a determination of fact rather than the essential question as to whether or not repairs may be deducted. Amounts expended to enlarge or improve facilities (not in the nature of permanent improvements) to take care of an expansion in business are deductible.[27] If such alterations are for the benefit of several periods, they should be written off over those periods rather than in the period in which the alteration is made. Even ordinary annual replacements of furniture and office equipment are deductible.[28]

There is nothing in these sections, regulations, and decisions which violates accounting provisions. The essential thing required both by accounting and the income tax is proper differentiation between capital and revenue expenditures.

Traveling Expenses

Net traveling expenses have been allowed to individuals. The individual is allowed to include such amounts as deductions and is required to show any reimbursements from his employer, as gross income. Since

an employing corporation pays such items ultimately, it is entitled to such amounts as deductions also.

Article 101, Regulations 62, 1922 edition, of the 1921 act specifies:

Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. . . . If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses.

(a) If, then, an individual, whose business requires him to travel, receives a salary as full compensation for his services, without reimbursement for traveling expenses, or is employed on a commission basis with no expense allowance, his traveling expenses, including the entire amount expended for meals and lodging, are deductible from gross income.

(b) If an individual receives a salary and is also repaid his actual traveling expenses, he shall include in gross income the amount so repaid and may deduct such expenses.

(c) If an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, the amount of the allowance should be included in gross income and the cost of such meals and lodging may be deducted therefrom.

A similar rule has appeared in all succeeding years.[29]

Rentals

RENTALS paid are deductible business expenses under all of the acts, including the first one in 1913. Sec. 12 (a) of 1916 states that among allowable deductions are included:[30]

(first) All the ordinary and necessary expenses . . . including rentals or other payments required to be made as a condition to the continued use or possession of property, to which the corporation has not taken or is not taking title, or in which it has no equity.

Both rentals and depreciation are service charges for the use of property. If one owns business property, he should depreciate it; if he rents, he should treat rent payments as expenses.

The rental provisions are broad enough to include other payments made by the lessee for the lessor in lieu of rent.[31] Dividends and taxes of the lessor paid by the lessee are deductible as rent.[32]

The 1938 regulations regarding rental deductions are the same as in 1918 and all intervening years.[33]

If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction

may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation.

Pensions

PENSIONS are payments made either directly to employees, as into a pension fund, or as social security taxes.[34] They are more similar in nature to additional compensation to employees than they are to taxes or contributions.

In 1913, it was provided that:

> Amounts provided for pensions to retired employees, or to their families, or others dependent upon them or on account of injuries received by employees, are proper deductions as "ordinary and necessary expenses"; . . .[35]

Substantially the same provision was made in 1916[36] and 1917,[37] but in 1918 and in later laws, it was expanded somewhat, as follows:[38]

> . . . paid as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. No deduction shall be made for contributions to a pension fund held by the corporation, the amount deductible in such case being the amount actually paid to the employee. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of the services rendered by the individual, such payments may be deducted. Salaries paid by employers during the continuance of the war to employees who are absent in the military or naval service or are serving the Government in other ways at a nominal compensation, but who intend to return at the conclusion of the war, are allowable deductions.[39]

Pensions may be deductible if paid either for injuries or retirement purposes. The 1913, 1916, and 1918 regulations specify that the pensions must be paid. In 1921 and subsequent years, the words "or accrued" are added. This is perhaps not very significant, since the law was drawn on an accrual basis.[40]

The regulations for the years of 1913 to 1926 inclusive, but not for the years of 1928 to 1938[41] inclusive, specify in the articles already noted that contributions to a fund the resources of which are *held* by the corporations are not deductible, and that in cases in which such funds are operated, only the amounts actually paid the employees are deductible.

The regulations for the years of 1928 to 1938 inclusive contain special provisions regarding pension funds, apart from the articles previously noted.[42]

Formerly, if the resources of the pension trust were held by the corporation, contributions to such fund could not be deducted by the

corporation. This held true even though the corporation was operating a *bona fide* pension trust fund. In 1928, it was decided that if the plan was *bona fide* and if title to the assets of the fund could not be repossessed, mere holding of the trust assets would not render contributions to the trust non-deductible.

However if the trust was revocable, contributions to such trust were not deductible and income of the trust was held income of the grantor.[43] For fiscal years starting after December 31, 1938, no part of the corpus or income of a trust organized under exempt employee trust agreements may be used for purposes other than the employees' benefits (unless all liabilities to employees have been satisfied).[44]

In discussing Section 23(q) of the 1928 act, the Senate Finance Committee[45] decided to permit trust funds set up under old corporation-controlled plans to be turned over to a trustee and administered as though independent for their entire existence. Since contributions were made to such plans in years prior to 1928, the Committee decided also that such past contributions might be deducted over a period of future years equivalent to the time during which the fund was accumulated.

Section 23(q) was then finally drafted to include approximately the above opinion expressed by the Senate Finance Committee. In its final form, Section 23(q) of the 1928 act stated:

> An employer establishing or maintaining a pension trust . . . for the payment of reasonable pensions to his employees (if such trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowed as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

The acts of the years subsequent to 1928 have included a similar provision but have added some additional information which is quoted below from Section 23(p)(2) of the 1938 act. The information in the 1932, 1934, and 1936 laws is similar in import to that of 1938, although slightly different in the details.[46]

> Any deduction allowable under section 23(q) of the Revenue Act of 1928 or the Revenue Act of 1932 or the Revenue Act of 1934, or under section 23(p) of the Revenue Act of 1936, which under such section was apportioned to any taxable year beginning after December 31, 1937, shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.

The regulations for 1928, 1932, 1934, 1936, and 1938 regarding pension trusts are substantially the same.[47] They specify that the plan shall be

reasonable, actuarially sound, and exempt from tax under Section 165 (i.e., for the exclusive benefit of employees).

Reasonable payments made directly to employees for pensions in regard to which no payment has been made to a pension trust shall be allowed as a deductible expense for the year in question.

If contributions are made into a trust, in advance of the granting of the pensions, to take care of future pension payments, the following deductions may be taken:

1. A reasonable amount representing the liability for the taxable year for future pension payments.
2. One-tenth of the amount transferred or contributed (a) to cover pension liabilities of prior years or (b) to place the trust on a sound financial basis shall be allowed as a deduction for the taxable year and for each of the nine succeeding taxable years.

If contributions are made under a plan which does not contemplate contributions to the trust in advance of granting the pensions, the following deductions are allowed:

1. Amounts paid to the trust in the year which represent the present value of expected future payments in regard to pensions granted to employees during the taxable year.
2. One-tenth of the amount transferred or paid to cover the present value of expected future payments in regard to pensions granted to employees retired prior to the taxable year or transfers or payments to place the trust on a sound financial basis shall be allowed for the current year and for each of the nine succeeding taxable years.

The right to such deduction is recognized even when the trust is not perpetual, so long as the trust is of such nature as to evidence the good faith of the employer actually to pay the amounts trusteed.

If any portion of the funds revert to the possession, ownership, or control of the employer upon the termination of the trust or otherwise, such amount is income to the employer when it reverts, unless it is suitably retrusteed.

Many decisions in addition to the regulations have supported the deductibility of contributions to a pension fund where it is a trust and a separate entity.[48]

Compensation to Employees

COMPENSATION paid to employees for services performed has always been considered a deductible business expense for income tax purposes. Limitations made in the acts regarding compensation paid have been made not in opposition to the deduction of such legitimate compensation but rather to prevent the abuse of the deduction privilege by disguising other disbursements as compensation.

Article 105 of Regulations 45 of 1918 specifies that:

> Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:
>
> (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible.

This provision is followed in all of the succeeding years,[49] with the exception of any items to be specifically mentioned.

No general rules have been laid down, but the following items have been considered in court and Board of Tax Appeals cases as the basis for decisions regarding reasonableness and necessity of compensation payments: compensation paid by competitors to employees who perform like services; whether or not compensation is paid in proportion to stock held; time and manner of fixing the remuneration; ratio to the profits remaining after the compensation; that it is purely payment for services; form or method of payment is relatively unimportant; proper authorization for additional salaries; burden of proving reasonableness is on the taxpayer; character of work and amount of responsibility; ease or difficulty of the work; danger; working conditions; time required; ability required; education and training required; future prospects; past compensation; living conditions in the locality; profitableness of the services to the employer; competition for the job; closed or open corporation; and intent to avoid taxes.[50]

The burden of proof lies on the taxpayer but the Commissioner may not arbitrarily substitute his opinion for the judgment of the directors of the corporation.[51]

Article 105 of 1918 goes on to state that dividends disguised as salaries shall not be deductible.[52]

> (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

Such payments are not deductible as salaries unless sufficient evidence is presented to prove that services were rendered and that the compensation paid is reasonable. Very many decisions, both favorable and unfavorable to the taxpayer, have been made solely upon the facts and evidence produced.[53]

Article 105 of 1918 and its successors[54] add the following regarding compensation deductions and the restrictions applicable thereto: "An ostensible salary may be in part payment for property. . . ."

The mere fact that compensation is contingent on the occurrence of certain antecedent conditions does not render it any less deductible compensation.

The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings . . . , it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying . . . at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

In any event the allowance for compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[55]

Excessive compensation shall be treated as a dividend, a capital expenditure, or as anything else which it may be in fact.[56]

In 1932, the Senate Finance Committee considered limiting the deduction of salaries to $75,000 for payments made to any one person.[57] An arbitrary restriction such as this would have been undesirable; if manipulation is suspected in any case, it can be handled as a separate problem, without inserting inflexible provisions such as this into the law. However, the suggestion of the Senate Committee was eliminated by the Conference Committee.[58]

Again in 1934, Congress considered and rejected an arbitrary limitation on the deduction of salaries. The proposal was made in order to raise more revenue, but no praise is to be accorded Congress for the rejection. The proposal was eliminated solely because it was not expected to result in additional revenue and not because the restriction was arbitrary and illogical. It appears that in 1934, the dominant idea was to raise revenue, however it might be done.[59]

The manner of making payment does not affect the deductibility of the compensation. In 1913, it was permissible to deduct commissions paid in stock, if charged on the books at the actual value of the stock.[60] Similar provisions exist in the more recent acts, as well.[61]

Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included. . . .[62]

Notes or other evidences of indebtedness received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value.[63]

Other means of payment for services which are includable as income to the recipient and deductible by the employer include: bonuses, commissions, percentage of profits, and pensions or retiring allowances. However, pensions or other payments made as gratuities are gifts and are not deductible.[64]

Payments made in other than cash present some difficulties of valuation. This is particularly true of compensation paid in stock. The income tax law specifies that the fair market value at the date of payment shall govern.[65]

In general it may be said that amounts paid as a reward for services are deductible expenses; amounts paid as goodwill offerings or gifts are not deductible. Article 108, Regulations 65, of 1924 may be considered representative of the provisions which have appeared in all of the laws from 1913 to 1938, inclusive.[66]

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind. . . . Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

In *Van De Kamps Holland Dutch Bakers* (2 BTA 1247, 1925) it was held that compensation in the form of a bonus has become a recognized form of salary payment used to retain the interest of the employee in the business without at the same time incurring any obligation in advance of the payment. The employee expects the bonus and considers it a part of his salary. Many decisions have been rendered upholding the deductibility of bonus payments.[67]

Miscellaneous

OTHER deductions allowable in full include legal expenses and entertainment expenditures made with the intent of promoting business.

Legal expenses incurred in defense of criminal prosecution are not deductible in the absence of evidence that the act which gave rise to prosecution was in connection with the taxpayer's business.[68] Many cases have been decided both in favor of allowing and against allowing legal expenses; most of these decisions depended on the specific facts, however.

A few decisions have disallowed deductions of entertainment expenses,[69] but these were decided unfavorably mainly on the facts presented, rather than upon the disallowance of such expenses in general. I. T. 2135[70] disallowed the cost of tickets bought to entertain a customer,

but this decision was reversed by the Board of Tax Appeals, and such items were allowed where they were a common trade practice.[71] There are a great number of decisions supporting the deduction of such items.[72]

Credits

PROVISION has been made in the income tax acts for certain credits against the tax or against the net income, in lieu of deductions from gross income subject to tax. In some cases a choice of the two is given, but both are not allowed, of course. The allowance of a credit is recognition under the income tax law of the deductibility of a given item. They sometimes operate to make certain incomes partially or completely tax free. Credits against income, rather than against the tax, are roughly equivalent to deductions for normal tax computations.

CREDITS AGAINST INCOME

War and Excess-Profits Tax

NO MENTION was made in the 1913 and 1916 revenue acts about a credit for war and excess-profits tax, but, in 1917, Section 1211 stated:

> That in assessing income tax the net income embraced in the return shall also be credited with the amount of any excess profits tax . . . assessed for the same year.

A similar provision was in the 1918[73] and 1921[74] acts but was not repeated in 1924.

Tax Free Minimum

IN 1918, a domestic corporation was entitled to \$2,000 of tax-free income. This was accomplished by allowing a \$2,000 credit against income.[75] The \$2,000 credit was allowed in 1921 only if the net income was \$25,000 or less, but an equalizing provision was included in the case of incomes slightly in excess of \$25,000.[76] The credit was raised to \$3,000 in 1928.[77] The 1932 and succeeding acts contain no similar provision.

Needless to say, from the standpoint of correct net income calculation, a provision such as this can not be defended. Its defense lies within the realm of expediency and public policy.

Interest Received on Certain Obligations of the United States

THE 1913, 1916, and 1917 acts carried no mention of credits of this nature, but those of 1918 and succeeding years[78] have all provided substantially that among allowable credits shall be:

> The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income. . . .

In 1924, the provision regarding the War Finance Corporation became outmoded and was dropped.

In 1934, Sec. 26 added the provision that interest on obligations "of corporations organized under Act of Congress," whose interest is exempt from the normal tax of individuals under the act creating such corporation may be treated as a credit against income.

The credit for this item is designed to reduce income subject to normal tax. Since corporations are not subject to surtaxes, this credit merely accomplishes the complete exemption from tax of such interest received by corporations.[79]

Credit Against Tax

Income, War Profits and Excess Profits Taxes Paid to a Foreign Government or United States Possession

The acts of 1913, 1916, and 1917 were silent on the matter but that of 1918[80] stated:

Sec. 238(a) That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by title III shall be credited with the amount of any income, war profits and excess profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the U.S.

Under the then existing laws (1913, 1916, and 1917) a citizen could deduct foreign taxes only from gross income to arrive at net income. The high rates and heavy burden demanded relief. The bill provided a credit *against the tax* imposed in the United States, of an amount equal to the tax paid in such country upon income received from sources within such country.[81]

The 1921 act and succeeding laws[82] were substantially the same except that they added:

Provided, that the amount of the credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits, taxes imposed by any foreign country or possessions of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year.

Section 131(b)(1) of 1934 makes the limitation more strict:

The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year; . . .

In 1924 and subsequent years, the following subsection was inserted:

The credits provided for in subdivision (a) of this section may, at the option of the taxpayer and irrespective of the method of accounting employed in keep-

ing its books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject to . . . subdivision (b) of this section. . . .[83]

In 1934, the Ways and Means Subcommittee recommended the elimination of Section 131 of the Revenue Act of 1932. It was felt that corporations doing business abroad were being favored over those doing solely a domestic business, in as much as state income taxes are deductible only from gross income and not from the tax itself.[84] The Ways and Means Committee agreed with its subcommittee but did not make the elimination because the Treasury was anxious to avoid double taxation and to encourage foreign trade.[85]

Deductible—non-Deductible

Life Insurance Premiums

Life insurance premiums paid

on insurance on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the person insured are not deductible from the taxpayer's gross income.[86]

These items have been regarded in the nature of capital investments, and have been disallowed consistently by the income tax law.[87]

If the corporation is not a beneficiary, it may deduct the premiums paid.[88] After all, such payments are only additional compensation to the employee.

This deductibility was not always permitted. Prior to Section 1211 of the 1917 Act, a corporation was not allowed to deduct such premiums paid, regardless of the identity of the beneficiary.

Section 32 of the act of Sept. 8, 1916, specifically provides that premiums paid by corporations for insurance covering the lives of officers, employees, or those financially interested in the trade or business of such corporation, shall not be deducted from the gross income of the corporations paying the same. This provision is held to apply to all forms of life insurance, the premiums upon which the corporations may pay, whether or not the corporations are the beneficiaries of the insurance policies upon the death of the insured, and all rules and regulations in conflict with this article are hereby revoked.[89]

Since 1917 the deductibility of premiums paid by a non-beneficiary corporation have been upheld by the Bureau[90] and the courts.[91]

Workmen's compensation insurance premiums fall within the general rules laid down and are deductible expenses.[92]

An interesting case was settled in 1939. A dealer in securities took out insurance on the life of the President of the United States.[93] The taxpayer claimed that the premiums were an ordinary and necessary expense incurred to hedge against a possible future loss which would result were

the President to die. The Commissioner and the Board of Tax Appeals both disallowed this and held that it was unique, not ordinary or necessary. It is interesting to note also that one member of the Board dissented from this decision.

Additions to a reserve for self-insurance, even though equal to the estimated premium payable to a life insurance company, are not deductible.[94] There is some doubt that such disallowance is justified, however.[95]

Whether the premiums are deductible or not, the proceeds of such policies paid upon the death of the insured generally may be excluded from gross income. However, it might be better to allow such premiums to be deducted invariably and to tax the proceeds.

Contributions

CONTRIBUTIONS of any sort are deductible if they are ordinary and necessary business expenses. There has been a very definite change in recent years in income tax policy in regard to "contributions made to religious, charitable, scientific, or educational corporations."

The Regulations from 1913 to 1934[96] inclusive have been substantially similar and have specified the following:

1. Corporations may not deduct purely religious, charitable, scientific, or educational contributions.
2. Donations by corporations for purposes connected with the operation of business, when limited to charitable institutions, hospitals, and educational institutions conducted for employees or their dependents, are deductible as ordinary and necessary business expenses.
3. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions. They must bear a relationship to the business and be made with the reasonable expectation of a return commensurate with the amount of the donation. Outlays and the benefits to be reasonably expected must balance; the interests of the business must be advanced.[97]
4. An example of an allowable deduction is a donation by a street railway company made to bring a convention to a city.
5. Expenses incurred in the advertisement and promotion of liberty bonds and war savings stamps over the corporation name are deductible.
6. Lobbying, propaganda, non-trade advertising, and campaign contributions are not deductible.

Most contributions made by corporations are, in reality, made to benefit business. Since the reduction of tax is never as great as the contribution disbursement, it is usually safe to assume that the corporation expects to obtain certain other benefits. Seldom are such corporation donations made in the interests of pure charity.

This realistic interpretation of motive has not been followed in tax

decisions, however. Although the balancing of contributions against expected benefits is a matter for managerial judgment and not for second-guessing by the tax administrators, the Board of Tax Appeals has not taken this view. It held[98] that a corporation should be given much latitude in regard to its expenditures but that the Commissioner has the right to review and disallow unreasonable reductions of profits; each case must be decided on its particular facts.

The application of the law of deductible contributions has been extremely inconsistent and arbitrary.[99] This inconsistency is found in decisions of the Commissioner, the courts, and the Board of Tax Appeals.

Donations to a city,[100] contributions not justified as business expenses,[101] donations to obtain an army camp,[102] contributions to a civic fund for welfare purposes,[103] contributions for a public hospital,[104] and contributions to maintain roads into town[105] have all been disallowed.

Dues to trade associations,[106] cost of advertising liberty bonds,[107] donations for an army camp,[108] contributions for promoting railroad legislation,[109] contributions to repair a church,[110] donations to a public school district in which most of the pupils were employees' children,[111] expenses of welfare work for employees,[112] contributions to the American Protective Tariff League and the League of Industrial Rights,[113] contributions to a chamber of commerce,[114] contributions made to boom a town,[115] and other contributions in the nature of business expenses,[116] have all been held deductible.

No safe generalization may be made regarding the deductibility of particular items. In some cases, contributions were not allowed unless the business benefits were immediate and direct; in others, very indirect benefits were considered sufficient justification for allowing deduction.

Inconsistency can be found between decisions in cases in which the facts were the same or substantially so. A few of the more outstanding contradictory cases are the following.

A hotel company[117] made contributions to obtain an army camp in the neighborhood and also to improve roads into town. Both were intended to aid business, yet the road contribution was disallowed.

The Anniston army camp case is a very good example of inconsistency. Several business concerns contributed to bring an army camp to town in order to improve business. A deduction was allowed a real estate dealer,[118] but contributions by others were disallowed.[119]

In another case, five items were allowed and thirteen disallowed, although they all were quite similar in character.[120]

Several contributions affecting legislation were allowed, in spite of the fact that the regulations specifically disallow such items.[121]

In one unusual decision, it was held that a contribution was of lasting benefit to the business, a capital expenditure, and, therefore, non-deductible.[122]

The attitude of the Board is well-expressed in its own words:

While the contributions may have been business expense in a business and accounting sense, it is our opinion that they do not fall within the classification "ordinary and necessary expenses" as that phrase is used in Section 234 of the Revenue Act of 1918.[123]

It is important to notice that the courts reversed the above Board decision.[124]

Charitable and similar contributions have been allowed specifically to individuals[125] for some time, but until 1935 were not allowed to corporations unless they were proven business expenses.[126]

Section 23 of the Revenue Act of 1934 was amended in 1935, as follows:

In the case of a corporation, contributions or gifts made within the taxable year to or for the use of a domestic corporation, or domestic trust, or domestic community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children (but in the case of contributions or gifts to a trust, chest, fund, or foundation, only if such contributions or gifts are to be used within the United States exclusively for such purposes), no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation; to an amount which does not exceed 5 per centum of the taxpayer's net income as computed without the benefit of this subsection. Such contributions or gifts shall be allowable as deductions only if verified. . . .[127]

Up to this time, a contribution was deductible only if it was an ordinary and necessary business expense. Out-and-out charitable contributions were completely disallowed. The change in 1935 still permitted one hundred percent of contributions to be deducted if they qualified as business expenses. The 1935 provision was more liberal than its predecessors only in the case of non-business contributions; they were permitted up to an amount not to exceed five percent of the corporation's net income computed without regard to this subsection. In short, the change in 1935 gave the corporation a deduction it had never had available to it before.

The reason for the change is readily found. Public charity was bearing heavily on the taxpayers, and help from private charity was urgently needed.[128] It is difficult to understand why the Government has ever hesitated to allow such deductions, so long as they are made to recognized agencies.[129] A contribution of a charitable nature represents the equivalent of a tax payment used for charity.

If the corporation were not to so contribute, its increased tax on the enlarged net income figure would yield only a part of the amount of the contribution for use in public relief work.

It is interesting to notice that when a similar amendment was proposed in 1921, a five percent limitation was suggested, but was eliminated on the floor of the Senate.

The 1935 provision remained unchanged in 1936[130] and 1938,[131] but a new subsection[132] was added in 1938 which stated:

> No deduction shall be allowable under paragraph (1) to a corporation for any contribution or gift which would be allowable as a deduction under subsection (q) were it not for the 5 per centum limitation therein contained and for the requirement therein that payment must be made within the taxable year.

There has been some question as to the meaning of this subsection. Does it mean that if an expenditure can be classified as both a business expense and as a charitable contribution, within the meaning of Section 23(q), that its nature as a business expense must be ignored and that it will be entirely subject to the five percent limitation? Or does it intend merely to carry forward the old full deductibility of contributions in the nature of business expenses and in addition to allow pure non-business contributions within the five percent limit?

The Ways and Means Subcommittee apparently favored the restriction of the deduction of any contribution which could qualify under Section 23(q) to the 5 percent limitation, even though it might also be a business expense.[133] The full Ways and Means Committee, however, reported:

> The limitations of Section 23(a) (2) apply only to payments which are contributions or gifts. A deduction is not to be disallowed under Section 23(a) (2) of the bill merely because the recipient of amounts received from the corporation is a so-called charitable organization within the meaning of Section 23(q), as, for example, in the case of a payment by a mining company to a local hospital in consideration of an obligation assumed by the hospital to provide . . . for the employees of the company.[134]

The latter appears to be the more desirable construction to be placed on the new provision, although there is no certainty that such is actually the case.

Regulation 101, 1928 appears to favor the liberal interpretation:

> No deduction is allowable under section 23(a) for a contribution or gift by a corporation if any part thereof is deductible under section 23(q). Thus, for example, if a corporation makes a contribution of $5,000, only $4,000 of which is deductible under section 23(q) (whether because of the 5 percent limitation or requirement of actual payment, or both), no deduction is allowable under section 23(a) for the remaining $1,000.
>
> The limitations provided in paragraph (2) of section 23(a) and in this article apply only to payments which are in fact contributions or gifts to organizations described in section 23(q). For example, payments by a street railway corporation to a local hospital (which is a charitable organization within the meaning of section 23(q)) in consideration of a binding obligation on the part of the hospital to provide hospital services and facilities for the corporation's employees are not contributions or gifts within the meaning of section 23(q) and may be deductible under section 23(a) if the requirements of that section are otherwise satisfied.[135]

One authority[136] on income tax matters has stated that this provision in 1938 is a departure from the 1936 rule. He states that under the 1936 act if a corporation can prove its contribution is an ordinary and necessary business expense, it may deduct the amount in full. His opinion is that under the 1938 act the five percent limitation applies to all charitable contributions, even though they may be business expenses.

A further limitation is made to the effect that the deduction may be taken only in the year paid and not in the year of the pledge.[137] This restriction violates the accrual basis of income determination.

The law could be improved further if contributions were allowed to be deducted in full. They can be justified as business expenses or as contributions, the deduction of which furthers public welfare.

Interest

THE income tax conforms quite closely with accepted accounting thought regarding the proper treatment of interest. This situation has not always existed, however.

The deductibility of interest was recognized in the act of 1894, but only after the Senate forced through an amendment making interest deductible. Recognition of such deduction was not complete however. Interest was only partly deductible in 1913, and the law was upheld by a Supreme Court decision.[138]

The interest section of the 1913 act stated:

> . . . the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year; . . .[139]

The 1916 act and the 1917 act[140] were substantially the same in their limitation on interest deductions; it is interesting to notice that under the laws of 1913 and 1916 all interest paid by individuals was deductible. The acts subsequent to 1917 no longer restricted interest to a designated portion of invested capital. This limitation was probably designed to legislate against corporations with nominal amounts of capital stock. Those who form corporations with limited amounts of capital stock could gain the benefit of interest deductions if they were to take most of their securities in the form of bonds. Their chief gain would be to allow to the corporation the privilege of interest paid deductions, which deduction is denied for dividend payments. The government, in this limitation, was attempting to prevent the juggling of the capitalization by corporations to manipulate their deductions.[141]

It would appear that this is a recognition of the fact that all equities

are basically alike and that interest and dividends are similar. Perhaps, both interest and dividends should be completely deductible or completely non-deductible, but it is difficult to see why either should be partially deductible or why one should be allowed while the other is disallowed.[142]

It is interesting to notice also that under the 1913 and 1917 acts, interest was stated to be deductible only if accrued and *paid* within the taxable year.[143] In the 1918 law and its successors, payment was not stated as necessary so long as interest was paid or accrued within the year.[144]

Although the 1916-1917 acts apparently refused deduction to accrued interest not paid within the taxable year, the regulations of those years permitted accrued interest to be deducted if properly entered on the books.[145]

It has been held satisfactorily in many decisions that the accrual basis for deducting interest is proper.[146] The time for deducting interest is the period within which the liability accrues, regardless of when payment is actually made.[147]

Discounts and premiums on bonds payable are adjustments to interest and should be amortized by taxpayers on the accrual basis of accounting.[148]

A further limitation was introduced in 1917,[149] and it has been continued in the succeeding acts.[150] Interest on indebtedness incurred for the purchase or carrying of obligations the interest upon which is exempt from taxation as income is not deductible. A provision such as this is quite fair, but the law would be improved if the income were taxed and the deductions were allowed.

The 1918 and subsequent acts[151] were a bit more liberal than that of 1917. They permitted interest paid to be deducted even though incurred to purchase certain tax-free interest bearing securities. This exception was limited, however, to obligations of the United States issued after September 24, 1917, because they are not wholly tax-exempt. Very obviously, this was permitted in order to aid in the prosecution of the War. A later restriction[152] was introduced to the effect that such exemption would be allowed only to the original subscribers of 3¾ per cent Victory Notes, but the exemption relating to other issues after September 24, 1917, was not restricted to original subscribers.

The House bill in 1918 proposed to eliminate the restriction regarding non-deductibility of interest paid to acquire tax-free obligations, but the Senate restored it.[153]

In 1932,[154] interest "on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity" was declared non-deductible.

The theory for not allowing the deduction in regard to annuities was

that since the annuitant was not required to report annuity payments received as income (until they exceeded capital invested) he ought not to be allowed to deduct interest incurred to carry such annuities.

Under the 1934 bill, the annuitant was required to include as income a certain part of the annuity payment received each year as interest income; hence, the reason for denying an interest expense deduction no longer existed. The Senate Finance Committee then succeeded in having such provision eliminated from the 1934 act[155] and subsequent acts.

Interest not paid but merely calculated on the capital invested is not considered an accounting expense.[156] The idea of interest on capital as an element of cost is an economic concept rather than an accounting concept. Those who favor considering interest as a cost maintain that before profit is computed as a reward for risk-taking all rewards to the other factors in production (including the enterpriser as a capital contributor) must be deducted. There is much to be said for this point of view, even in accounting and tax matters. It is related to some extent with the proper treatment of interest and dividends paid.[157]

The accounting idea of cost or expense includes outlays made to others than the owners of the business. Under conditions found in modern open corporations, it is not certain that disbursements made to shareholders are different from those made to other creditors.[158] It might be possible to disallow interest on capital only to the extent that that capital represents accumulated earnings.

The income tax has quite closely followed general accounting thought in excluding interest on own investment from the income calculation.

The 1916-1917 regulations were:

> Interest calculated as being a charge against income on account of capital or surplus invested in the business but which does not represent a payment of an interest-bearing obligation, is not an allowable deduction from gross income, that is to say, the interest which the money would earn if otherwise invested is not a deductible charge against income.[159]

Substantially the same provision has been included in the regulations for all subsequent years.[160]

> Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock which is in reality a dividend thereon, can not be deducted in arriving at net income.[161]

Taxes

All sums paid within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country, are deductible from gross income.[162]

A provision such as this has always been included in the law since its enactment in 1913; in fact a similar section was provided in the act of

are basically alike and that interest and dividends are similar. Perhaps, both interest and dividends should be completely deductible or completely non-deductible, but it is difficult to see why either should be partially deductible or why one should be allowed while the other is disallowed.[142]

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Taxes

All sums paid within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country, are deductible from gross income.[162]

A provision such as this has always been included in the law since its enactment in 1913; in fact a similar section was provided in the act of

1894. The restrictive wording of this article was clarified a bit later, to include taxes paid to possessions of the United States and to local subdivisions of the several states.[163]

This general statement would be ideal to cover all taxes, with the possible exception of local improvement assessments; but some particular types of taxes have been declared non-deductible.

In 1913, the regulations stated that

> taxes paid by a corporation pursuant to a contract guaranteeing that the interest payable on its bonds or other indebtedness shall be free from taxation are not deductible.[164]

This provision is difficult to justify. The later regulations, including those of 1938,[165] provide as follows:

> Amounts paid to States under secured debts law in order to render securities tax-exempt are deductible.

Auto license fees are ordinarily considered taxes and are deductible as business expenses.[166] This Treasury regulation has been found in the law from the earliest years and is in complete accord with accounting and business practice.

Federal duties, excise, business, license, privilege, stamp, and other such taxes are all deductible as taxes, provided that they are not included in the cost of merchandise. If they are so included, they may be inventoried or included in the deduction for cost of goods sold, as the situation requires.[167] Again, this treatment has been used consistently in the income tax and agrees with accounting and business procedure.

Postage is not considered as a tax and may not be deducted as such;[168] however, it is a deductible business expense to be handled under a different caption. The effect on net income, of course, is not changed whether it is called a tax or other type of expense.

Contributions to state unemployment compensation funds are deductible in full by the employer to the extent that the contributions are those of the employer.[169] Amounts retained from employees' wages and contributed by the employer are not deductible by the employer, of course. If the employer pays the employees' share in addition to the employer's share, the full amount is deductible by the employer; it can be justified either as a tax or as an additional compensation to the employee.[170]

A true state sales tax is one which is levied on the customer; it is deductible by the customer only. A retailers' business tax is levied on the right to do business and is deductible only by the vendor. Whether or not the tax is deductible by one or the other depends on the way in which the state law has been drawn up.[171]

Income, war-profits, and excess-profits taxes of territories and possessions of the United States and of foreign countries are deductible from

gross income, provided a credit against the Federal income tax has not already been allowed to cover such items. In other words, a deduction or a credit, within certain limits, may be taken, but not both.

This provision has been in the acts of all the years[172] and is acceptable to businessmen and accountants. It does not apply to United States income, war-profits, or excess-profits taxes, however, except as stated below.

United States income, war-profits, and excess-profits taxes are not deductible; such taxes are deductible, however, if paid to territories or possessions of the United States or if paid to foreign countries.

The 1913[173] and 1916 acts did not exclude such taxes from deduction; it was not until the latter part of 1916 and the passage of the amended War Income Tax Law of 1917 that Federal income, excess-profits, and war-profits taxes were not allowed as deductions. All of the laws and regulations since 1917 have prohibited such deductions.[174]

The 1936[175] act permitted the deduction of the excess-profit tax levied per Section 106 of the 1935 act, and the 1938 law[176] permitted the deduction of the excess-profits tax levied per Section 106 of 1935 or Section 602 of 1938. This slight modification was designed to eliminate complications in computation.[177]

The change brought about in 1917 was probably induced by the desire to obtain added revenue for war use.

There appears to be no agreement among writers as to the nature of an income tax.[178] Some feel that it is an expense; others consider it is a distribution of profit, in the nature of a dividend paid to the government.

When the matter was discussed in 1917, Senator Jones of New Mexico advocated treating the Federal income tax as a distribution of profit. He said:

> The tax of the Federal Government is not a part of the expense of business in accumulating the income the same as other taxes, but it is a part of the income itself, and is not an item which can properly be charged to expense, because we are supposed to take a part of the thing which was accumulated at the end of the business year.[179]

Why should the income tax be considered a division of profits just because it is measured by income? It is not essentially different from any other tax except in the manner of calculation. If it is a division of profits, why should not the share granted to the government be computed according to the dividend laws used in distributions to shareholders? The share of the government is an involuntary, arbitrary levy and should be treated as such. An interesting question would be raised if the income tax were reworded to make it a tax on doing business, as was the case in an earlier year.[180] Would it then qualify as a deductible excise tax? Can a mere change in words alter its essential nature?

Opposing Senator Jones in the 1917 discussion was Senator McCumber:[181]

. . . it is clear that the purpose of the law was that the tax should be paid upon net income. Every dollar that was paid out in a given year for taxes, the same as every dollar that was paid out that year for labor or clerk hire or for interest or for any other purpose pertinent to the business, was deducted from the gross income. Necessarily that which a man must pay in cash during any year must be deducted from that which he receives in any year in order to determine what he has made that year. Now, we have proceeded upon that theory in the law of 1913 and the law of 1916. For some unaccountable reason . . . the Commissioner has made a difference between taxes paid to the Government and taxes paid to a State or Municipality.

There is no more reason for exempting from the deduction taxes paid to the United States than there would be for excepting any other taxes. They are part of the expenses paid by the taxpayer, no matter to whom paid.

But those who support this proposition say that the taxes paid this year are taxes levied on last year's earnings, and therefore ought not to be deducted from this year's profits. That was the only reason given. That assertion falls the moment you apply to it the test of reason. . . . It is a part of the 1917 expenses. You are not allowed to deduct, during one calendar year, what you may think you will have to pay the next calendar year.

A letter by Carmen Blough answering many inquiries regarding the method of handling Federal income and excess-profits taxes in financial statements for the Securities and Exchange Commission indicated his concept of such taxes apparently as an expense rather than as a distribution of income. His words were:

In my opinion, provision should be made in the profit and loss or income statements for each of these taxes, whether the period covered by such statements is a full year or only a part thereof.[182]

The sections of the acts and the articles of the regulations for all of the years of 1913 to 1938 inclusive[183] have provided that *local benefit assessments* of a type tending to increase the value of the property assessed are capital expenditures and are not deductible. The regulation for 1921 is representative:

So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. . . . When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense incurred in business, if the payment of such assessments is necessary to the conduct of his business. When the

assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible . . .

This provision meets with the approval of the Board of Tax Appeals[184] and of accountants.

In 1924 and 1926 only the regulations included the following:

The gift tax imposed by section 319 of the statute is deductible from the gross income of the donor.[185]

It is doubtful if the matter of *gift taxes* is important to corporations. They usually are not considered able to make outright gifts of their assets. Their contributions usually classify as deductible business expenses or charitable constributions.

Taxes are deductible as such only by the person upon whom they are imposed.[186] Thus the taxes imposed by section 600 of the act upon sales by the manufacturer are not deductible by the individual purchaser, even though such taxes are actually billed to him as separate items.[187]

This provision appeared in 1924 and has been continued to the present.[188]

The above regulations appear to be fair, but other articles and sections are apparently in contradiction. In 1924 and 1926, the regulations stated:

In computing the net income of an individual no deduction is allowed for the taxes imposed upon his interest as shareholder of a bank or other corporation, which are paid by the corporation without reimbursement from the taxpayer. The amount so paid should not be included in the income of the shareholder.[189]

And in the acts of 1928 to 1938 inclusive,[190] the following was supplied:

The deduction for taxes allowed by subsection (c) shall be allowed for the taxes imposed upon his interest as shareholder of a bank or other corporation, which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

A provision which allows a corporate taxpayer to deduct expenses not its own is just as reprehensible as one which prevents the taxpayer from taking all of the deductions he should take to reduce gross income to the proper figure.

From a theoretically correct point of view, taxes should be accrued and matched against the income with which they are related.

The law and Regulations in 1913, 1916, and 1917 denied the right to deduct a reserve for taxes.[191] Article 153 of Regulations 33 of 1913 stated:

Reserves for taxes can not be allowed as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted.

And article 158 of the same year said:

Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation.

In 1918 and succeding years,[192] the law has provided that taxes "paid or accrued" may be deducted.

In 1930,[193] the Supreme Court held that a tax accrues (under the 1918 act) and is deductible when it becomes a liability of the taxpayer.

In *United States v. Anderson* (269 U.S. 422, 1926), the Supreme Court upheld the deductibility of accrued taxes.

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and become due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

Emphasis on due date as the time for deduction is also found in other decisions.[194] Several rules have been laid down regarding the date when a tax becomes due. City and state real estate taxes in Louisiana were held a lien on property only after the assessment rolls are filed. The tax lien thus attached in the year of the assessment rather than in the year for which the taxes were assessed.[195]

Earlier rules of the Treasury Department fixed the time of the accrual of state property taxes as the date when the tax roll was turned over to the collection officer, but these decisions were revoked in 1929,[196] and taxes were said to accrue on the date on which, per state law, the ownership of the property creates a liability on the part of the owner for the taxes levied. A similar rule provided that ownership of property on the date of assessment creates a liability for taxes.[197]

These latter rules are more satisfactory than those which set the due date of taxes as the date on which rolls are collected. It would be better if it were made more clear that taxes are an expense of the year for which levied and should be accrued for that year. The date of assessment for collection does not really fix the time of the tax. It is true that the amount of the tax is not known until assessment has been made, but the exact amount of the tax is not necessary for accrual purposes.[198]

The nature of accruals appears to be better understood in several cases involving the deductibility of taxes when property is sold before the date of tax payment. It has been held that if property if transferred after the accrual date of taxes, the purchaser may not deduct them although he pays the taxes; they are an additional cost of the property purchased.[199] This appears to be correct. The purchase price is usually reduced by the amount of accrued taxes to be assumed by a purchaser.

Non-Deductible

Capital Expenditures[200]

A capital expenditure is one which is made to acquire commodities or services to be used in the production of income in more than one period of time. Periodicity, therefore, is the cause for maintaining a differentiation

between capital and revenue expenditures.[201] The latter are those made for services or commodities which expire in the period in which the expenditure is made.

A suitable "matching" procedure requires that expenditures made for the future be treated as deferred charges to be applied against gross income of the future. Such items should not be deducted when the expenditure is made.

The income tax law has granted recognition to the necessity for treating capital expenditures as non-deductible items. The deductibility of some is allowed in future periods.[202] So-called capital expenditures include prepaid or deferred items as well as fixed assets. They are all similar in nature.

As early as 1913, the act provided

> that no deduction be allowed for an amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate.[203]

The same provision is found in the 1916 and 1917 laws, but the words

> and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof, for which an allowance is or has been made,

were added.[204] This provision has been repeated in all of the subsequent laws.[205]

The regulations of the Commissioner of Internal Revenue have been in harmony with the law. In 1913, the regulations stated:

> Amounts expended in additions and betterments which constitute an increase in capital investment are not a proper deduction;[206]

and in 1916 there was added:

> but such expenditures when capitalized may be extinguished through annual depreciation deductions which latter deductions will be computed upon the basis of the cost and probable life of the property.[207]

In addition to granting recognition to the non-deductibility of capital expenditures, the regulations clarify the law by enumerating certain items which are considered capital rather than revenue expenditures.

Ordinary repairs are revenue charges and not capital expenditures.[208]

> Incidental repairs which neither add to the value of the property nor appreciably prolong its life, but keep it in an operating condition, may be deducted as expenses.[209]

Organization and reorganization expenditures are capital items and are not deductible, although the Bureau, in the interests of expediency, overlooks this in the case of very small items which have no appreciable effect on the income figure.

Article 582, Regulations 69, of the 1926 act is typical of the attitude of the Bureau, even before 1926.[210]

Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are ordinarily capital expenditures, but where such expenditures are limited to purely incidental expenses, a taxpayer may charge such items against income in the year in which they are incurred. A holding company which guarantees dividends . . . of a subsidiary . . . for . . . securing new capital . . . and increasing the value of its stock holdings . . . may not deduct amounts paid in carrying out this guarantee . . . but such payments may be added to the cost of its stock in the subsidiary.

The disallowance of an immediate deduction for organization expense is sanctioned by accounting practice and theory.[211] A Treasury Decision and its supporting Board of Tax Appeals and court opinions to the effect that organization expenditures are never deductible is not in accord with accounting thought, however. Treasury Decision 2499[212] held that organization expenses are capital expenditures but that they may not constitute proper additions to the cost of any physical property to be provided for through annual depreciation allowance. Accountants hold that organization expenses are not to be added to any physical property, but should be amortized.

Deferred dues, subscriptions, and contributions are not deductible as ordinary business expenses but may be deducted only to the extent that they affect the present period.[213]

Sinking fund contributions and charges to surplus for getting up a sinking fund reserve are not deductible. The former is a capital charge; it should not even be called an expenditure, since it merely represents a transfer of assets. The charge to offset the credit to a sinking fund reserve is not an expense, nor is it a capital expenditure. It is merely a book entry allocating surplus.

The regulations contain recognition that such items are not to be deducted, although the language used is somewhat confused.

Article 166, Regulations 33, of the 1916-17 act explains the matter thus:

When a corporation sets aside a part of its earnings for the purpose of creating a sinking fund with which to retire its bonded or other indebtedness, the annual additions to such funds are not allowable deductions from gross income as or in lieu of depreciation or on any other account. The earnings thus set aside are an asset of the corporation and any accretion thereto must be accounted for as income.

The costs of defending or perfecting title to property is a part of cost and is not a deductible expense.[214]

Experimental and development expenses are capital expenditures and may not generally be deducted for income tax purposes.[215] But experimental work which does not result in the acquisition, development, or improvement of a capital asset is deductible.[216] This latter takes on the nature of a loss and should not be capitalized.

This differentiation has been applied to patents, also. Expenditures for

developing patents should be capitalized,[217] but after the patent has been established by suit, any recurring legal cost should be written off to Profit and Loss.[218]

Development work should not be capitalized after the developed or production stage is reached unless an extension of facilities results in more than is necessary to maintain existing output or facilities.[219]

In the case of intangible expenses incurred in connection with the development of oil wells, it has been held that they may either be treated as deductible expenses or as capital.[220]

It has also been held that the building up of newspaper circulation is a capital expenditure, and that the cost of maintaining but not expanding circulation is an expense.[221]

Commissions and expenses of buying securities "are a part of the cost of the securities and are not deductible as ordinary and necessary business expenses."[222] Fees paid for registration of securities under the Securities and Exchange Act are capital items and not deductible.[223]

Expenses of moving machinery or other property are deductible as an ordinary expense.[224] Such expenses should not be capitalized as a fixed asset, although they might be treated as a deferred charge to be spread over the periods which are expected to benefit from the work done.

In accounting practice, it is considered satisfactory to capitalize costs of getting machinery and equipment into place or condition for use, but the Board of Tax Appeals has directed that the cost of transporting newly purchased vessels be excluded from the cost of those vessels.[225] A similar decision was rendered[226] in which a lessor was permitted to deduct the full cost of installation work at the time of installation. Under very similar conditions it was held that installation costs of leased apparatus must be capitalized and recovered through depreciation deductions.[227] This latter ruling appears to be more in accord with accounting methods.

In conformity with accounting opinion, the income tax law provides that the cost of razing old buildings is to be added to the cost of land purchased with the intent later of erecting thereon new buildings. The intent when the purchase was made is important, otherwise a deductible loss would result.[228] This procedure of capitalizing such costs does not meet with universal approval.[229] It has even been held by the Board that an excessive cost of erecting a building should be capitalized;[230] it would seem better, however, to treat such an item as a loss.

Accountants[231] agree with the income tax provisions[232] which permit carrying charges on unimproved and unproductive real property to be capitalized. Carrying charges include interest paid to carry such property,[233] but do not include advertising or maintenance charges thereon.[234] Expenditures for alterations and improvements of leased property are capital items and should be exhausted over the life of the lease.[235]

A holding company may not deduct but must capitalize payments of guaranteed dividends of a subsidiary made to secure capital for the subsidiary and to increase the value of the investment in the subsidiary.[236]

Expenses of reorganizing a corporation, commissions paid to purchase securities, architects' fees, costs of defending or perfecting title to property, and costs of securing copyrights and patents are all capital expenditures and not deductible when made.[237]

The problem of distinguishing between capital and revenue expenditures in individual cases is not easy. The income tax law has provided that the cost of improvements with a useful life longer than the current year should be capitalized.[238] Expediency has been recognized, however, and small items charged off when made need not be capitalized.[239]

Capital items are those which are expected to be used up in the production of future revenue. Such expenditures should be matched against their related income inflows. The primary thing to be considered is whether or not the item acquired has a life greater than the current accounting period.

Lobbying and Campaign Expenses

THE GOVERNMENT has always considered that lobbying[240] and campaign expenditures[241] are not ordinary and necessary business expenses. There has also been the feeling that public policy requires that such expenditures should not be encouraged by allowing them to reduce taxable net income.

> Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, and contributions for campaign expenses are held not to be ordinary and necessary expense in the operation and maintenance of the business of a corporation, and are therefore not deductible from gross income in arriving at the net income upon which the income tax is computed.[242]

Fines and Penalties

FINES and penalties for violating the law are not deductible;[243] in this, they differ from civil judgments rendered and paid. To allow the deduction of such items as fines is contrary to public policy. This prohibition includes penalties assessed in connection with Federal taxes.[244]

Expenses of defense against criminal charges are generally not deductible, but they have been allowed sometimes. Apparently conviction or lack of conviction exerts some force on the allowance or disallowance of such items as deductions.[245]

Expenses Allocable to Tax-Exempt Income

A NEW subsection was introduced in the 1934 act that was continued in 1936 and 1938, to the effect that:

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this title;[246]

is not deductible from gross income.

The Ways and Means Committee of the House, in discussing the 1934 provision, stated that expenses incurred in obtaining interest on state securities and other exempt income should not be treated as deductible expenses.[247] In general, the Senate Finance Committee agreed but said:

. . . it is not believed that this disallowance should be made to apply to expenditures incurred in earning tax-exempt interest. To do so might seriously interfere with the sale of Federal and State securities, which would be unfortunate during the present emergency. Accordingly, your committee recommends that the disallowance be applied to all classes of tax-exempt income except interest.[248]

This point of view of the Senate Committee prevailed in Section 24 of the 1934 act.

This exception regarding the allowance of expenses incurred to get tax-free interest is inconsistent with the provisions of the act prohibiting deduction of interest expense incurred to purchase or carry tax-free securities.[249]

As early as 1928, the Commissioner was upheld in his allocation of expenses between taxable and non-taxable income and in his disallowance of expenses attributable to the latter.[250] In conformity with the ruling of the court, G.C.M. 9954 was issued to the same effect.[251] G.C.M. 9945 was modified in 1931[252] to exclude expenses attributable to tax-exempt interest or to other situations not within the scope of the facts involved in *Lewis v. Commissioner* (47 F. 2d 32.)

The Board of Tax Appeals upheld this interest exception under the 1932 act by permitting the deduction of a trustee's commission, although part of the trust income was tax-exempt interest.[253]

In this matter the emphasis is on expediency in revenue collection rather than on proper income computation. All expenses should be deductible and all income taxable. If, however, the income is exempt, all expenses associated with it should be disallowed.

Unpaid Expenses and Interest

When Section 24 of the 1936 act was amended in 1937,[254] a new type of non-deductible expense was created.

In computing net income no deduction shall be allowed in respect of expenses incurred under section 23(a) or interest accrued under section 23(b)—

(1) If not paid within the taxable year or within two and one half months after the close thereof; and (2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not,

unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and (3) If, at the close of the taxable year of the taxpayer or at any time within two and one half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b).

This provision was placed in the law pursuant to a campaign to prevent tax avoidance schemes by affiliated taxpayers. In certain cases, corporations deducted interest on the accrual basis, but recipients on a cash basis did not report income until it was received. It was felt that revenue urgently needed by the Government was being unduly delayed.[255]

Bona fide, arms-length transactions are not affected; only colorable transactions between related parties are within the scope of this subsection. Even in the case of these latter, it does not apply if both the payor and payee are on the accrual basis.

There has been no change in this provision in 1938.[256]

Dividends Paid

Dividends paid have never been allowed as deductions from gross income under the income tax law. The matter has been stated well by the 1916-17 regulations.

> So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at the net income. For the purpose of the tax, dividends of whatever character can be paid only out of net income, and the net income is subject to the tax, and for this purpose can not be reduced by any distribution among or payment to its stockholders.[257]

There may be justification for treating dividends as interest is treated, either as completely deductible or completely non-deductible. Whether or not one is willing to treat dividends and interest in the same fashion depends upon his conception of the sameness of creditors and shareholders.[258]

The disallowance of dividends as a deduction from gross income for tax purposes is in complete accord with accounting practice.

Chapter Summary

Although the Federal income tax was intended to be a net income tax, it is not truly one. The statutes and the Supreme Court have decided that the tax is in reality a tax on gross income modified only by those deductions which Congress chooses to allow.

Over the full term from 1913 to 1939, the income tax law has contained provisions to the effect that the tax is on net income computed according to accounting methods, but that certain deviations from accounting procedures are to be allowed. Ordinary and necessary business expenses have

always been considered deductible; again, subject to certain items Congress may not wish to allow.

Generally speaking, the items Congress has considered deductible have been so considered over the entire span of the income tax law. Within this group fall: ordinary repairs made to maintain satisfactory operating conditions; rentals or other payments equivalent to rentals made for the use of property; traveling expenses; and certain other business expenses such as legal fees, entertainment expenses, etc.

Reasonable compensation paid to employees for services rendered are deductible, even though they are paid in the form of bonuses. In 1932 and 1934, suggestions were made that the deduction allowed for salaries paid to any one individual be limited to a certain arbitrary figure to be set by law. These proposals were expedient measures only and were defeated.

Pension payments made directly to the beneficiary have always been deductible, but varying rules have been applied to contributions made by an employer to a pension fund. From 1913 through 1926, no deduction was permitted for payments made into a pension fund the assets of which were held by the corporation. If the pension fund was altogether distinct from the employer, however, contributions to it were deductible. In 1928, liberalizing provisions were introduced and were made to apply retroactively within limits. Contributions made to a pension fund held by the employer were made deductible, provided the fund was established for the sole benefit of the employees and was irrevocable. Apparently, correct theory has been recognized under the law but has been modified to prevent tax avoidance or evasion operated under the guise of pension plans.

In addition to the full deductions allowed, as such, there have been allowed certain credits against income. These credits operate in much the same way as do deductions.

One such credit has appeared for the period from 1918 to 1938, inclusive. Interest received on certain obligations of the United States and of certain corporations organized by act of Congress have been permitted as credits against income for normal tax purposes only.

Another such credit is that which allowed a certain tax-free minimum of income. In 1918 a $2,000 tax-free minimum was allowed; a similar credit was continued in the years from 1921 to 1926 but was limited to corporations with a net income of $25,000 or less. An equalizing adjustment was allowed for corporations which were just above the $25,000 dividing line.

Life insurance premiums and charitable contributions fall within a class of expenditures which are deductible only under certain circumstances.

From 1913 to 1916, no deduction for life insurance premiums paid by

a corporation was permitted under any circumstances. In 1918 a deduction was permitted a corporation if it was not the beneficiary under the policy. The old rule regarding disallowance remained in force in cases in which the corporation was beneficiary. Proceeds from life insurance policies are not taxable to the beneficiary and premiums paid are not deductible. It might be more logical to permit the taxation of the proceeds and the deduction of the premiums.

At no time have self-insurance reserve provisions been considered a proper deduction.

Up to 1934, purely charitable contributions were not deductible by a corporation. In the period 1935 through 1938, a deduction with a 5% limitation was permitted. In all of the years from 1913 to 1938, full deductions for contributions to charitable organizations were permitted if they could be justified as "ordinary and necessary" business expenses. In 1921, a proposal similar to the change made in 1935 was defeated.

From a social viewpoint, as well as from the standpoint of correct income calculation, it is difficult to understand why properly safeguarded charitable contributions should not be allowed in full. The decisions regarding this matter are in an extremely chaotic condition caused by arbitrary and inconsistent rulings.

Interest and taxes are representative of general classes of items whose subclassifications fall into both the deductible and the non-deductible expenditure groups.

Since 1918, interest, in general, has been fully deductible. Prior to that time, an arbitrary limitation was placed on the amount of interest to be permitted as a deduction by a corporation. The limitation was fixed at the amount of interest on one-half of the sum of the interest-bearing indebtedness and the outstanding capital stock of the corporation. The purpose of the limitation was to prevent manipulation of tax by means of juggling the capitalization of the corporation. An incidental result was partial recognition of the possible similarity between shareholders and creditors.

Interest paid to purchase or carry tax-exempt securities has been disallowed during the entire period of the income tax since 1917. Prior to 1916, there was no such rule. In 1918, the rule was relaxed in favor of certain government securities, the interest income from which was not fully tax-exempt. This right was restricted, however, in 1921 to the original subscribers of such securities. A proposal in 1918 to eliminate this non-deduction rule was defeated.

Statistical interest on invested capital, as contrasted with interest paid or accrued for payment, has never been permitted as a deduction.

Generally, taxes have been deducted over the full span of the income tax law. This rule applies to auto license fees, Federal duties, excises,

licenses, stamp taxes, etc. Taxes paid to a state by a corporation in conformity with a guarantee that the interest on its securities would be tax-free were not allowable deductions in 1913 but have been permitted since the 1918 act.

Postage is not deductible as a tax but is deductible under the heading of general operating expenses. The difference is of no great importance, of course. Local benefit taxes are properly held to be capital items and not deductible. Both of these provisions have always been a part of our income tax system.

Sales taxes are deductible by corporations, sometimes as a vendor and sometimes as a vendee. Whether the vendor or the vendee is to take a deduction depends upon the state law. The general rule is that taxes are deductible only by the person upon whom they were levied, but some contradictions to this provision are found in the law.

Income, war-profits, and excess-profits taxes were deductible in the acts of 1913 to 1916, but no credit against income was mentioned. No deduction was allowed in the laws of 1917 through 1938, but a credit against income was permitted from 1917 to 1921. An extremely slight relaxation of the rule has taken place under the 1936 and 1938 acts.

Income, war-profits, and excess-profits taxes assessed by foreign countries or possessions of the United States have always been permitted as deductions. In certain years, the taxpayer has been granted an option of taking a credit against the tax to be paid instead of a deduction from income for the amount of such excess-profits, war-profits, or income taxes assessed. This privilege was granted first in 1918 and has been continued ever since. The amount to be credited against the tax is based on the relative amounts of income the taxpayer has derived from sources within the United States, outside of the United States, and within the country whose tax the taxpayer is attempting to credit against the Federal income tax computed.

In 1934, it was suggested that this credit be abolished, but it was retained in order not to discourage foreign trade. There was a slight tightening-up, however, in the method for computing the tax under the 1934 act.

Among the items which have always been disallowed fully are capital expenditures, charges to surplus to set up surplus reserves, lobbying and campaign expenses, fines and penalties for law violations (not civil judgments), and dividends. Capital expenditures include: organization expenses, sinking fund contributions, expenses of perfecting title to property, experimental and development expenses, commissions and expenses connected with the purchase of securities, carrying charges on unimproved and unproductive real estate, and the cost of razing old buildings on land purchased with the intention of erecting new buildings thereon.

Maintenance expenses are not included in the carrying charges required

to be capitalized. There appears to be some confusion among the decisions regarding installation and "break-in" expenses. In some cases they were required to be capitalized; in other cases, not.

As early as 1929, perhaps earlier, the courts upheld the disallowance of expenses allocable to tax-free income. The 1934, 1936, and 1938 acts included provisions equivalent to the above court rulings and to Bureau rulings which followed the court decisions. One peculiar and inconsistent exception was made, however. Expenses attributable to the acquisition of tax-free interest were continued as allowable deductions.

In the 1936 and 1938 acts an entirely new type of disallowed expenditure was created. Interest or expenses not paid within two and one-half months after the taxable year by a taxpayer corporation on the accrual basis to a person on a cash basis are not deductible. This rule applies only to "colorable" transactions between related parties.

The computation of income on a logical and consistent basis would be aided greatly by the elimination of tax-exempt income and related disallowed expense groups.

The content of this chapter is not exhaustive of the subject of *deductions*. Non-recurring items such as the following are discussed in Chapter V: capital losses; unrecovered asset balances at voluntary removal of the asset; loss of useful value; unamortized balances of assets; abandonment losses; losses on the disposition of installment obligations, sale of goodwill, sale of patents and copyrights, sale of mines and oil and gas wells; losses on real property sold in lots; security losses; uncollectible deficiency on the sale of mortgaged or pledged property; short sales; bad debts, bad debt reserves; and worthless securities.

Reserves and the time for taking deductions are treated in Chapter III. Items affecting corporations as shareholders of other corporations are discussed in Chapter VI. The amortization of assets is treated in Chapter IX, and the treatment of inventories and cost of goods sold is handled in Chapter X.

CHAPTER IX

AMORTIZATION

THE SUBJECT OF AMORTIZATION is exceedingly interesting but is very complex and extensive. Most of the discussion of the subject has to be omitted from this chapter because of the limited scope of this study. There is included almost no treatment of the methods of computing the amounts to be charged against gross income.

In this chapter, the word amortization is used as an inclusive term which covers depreciation, depletion, and amortization (used in a narrow sense). Depreciation, depletion, and amortization (narrow sense) are all similar in nature, but there is a slight difference between the assets to which they apply and between the detailed methods for computation. All three are merely a spreading of the price of long-lived assets over several accounting periods.[1] Long-term assets are merely deferred costs of operation, and amortization charges represent the expiration of such assets and the inclusion of such expired parts as deductions from gross income.

The attitude of the Supreme Court has not been very consistent as to the nature of depreciation. In some early cases it has held that depreciation is not a cost of doing business.[2] In several other cases, it held that the principal purpose for making depreciation entries is to finance the replacement of the assets expired.[3] The cost conception has also been upheld.[4] These decisions were all handed down in public utility rate making cases, however, and may not be entirely applicable to income tax situations.

Depreciation is not considered by most accountants as intended for replacement purposes[5] or for evaluation.[6] At one time, there was some support among accountants for the loss of value conception of depreciation,[7] but it has lost favor.

It can not be denied successfully that the interrelationships inherent between transactions cause amortization entries to have an effect on replacement and on the balance sheet expression of fixed assets, as well as on income computations. The accumulation of cost, valuation, and replacement effects of amortization all occur to some degree; the question is upon which of these the emphasis is to be placed.[8] As has been mentioned previously, most accountants have emphasized the idea of the expiration of a deferred charge.

Methods of Computation of Amortization Charge

A THOROUGH discussion of detailed methods for computing amortization charges is not within the scope of this study; therefore, only brief mention of the subject is made. The Bureau favors a straight line method but recognizes other accepted trade practices, especially the output method.[9] The inventory or appraisal method for estimating depreciation did not meet with the approval of the Board[10] in one case, because it gave a result materially different from that which would have resulted from the straight line method. In a later case, the Board overruled the Commissioner, who attempted to force the use of the straight line instead of the observed depreciation method.[11] Apparently, the taxpayer's method will be upheld if it accurately reflects the depreciation although it may differ from the Commissioner's method.[12] The Bureau declined to approve or disapprove the declining balance method in advance of an audit of the taxpayer's return.[13] The unit of production method has been accepted by the Board in many cases.[14]

Accountants recognize several methods of computing depreciation but appear to favor the straight line method[15] and the output method.[16]

Calculation of the Amount of Periodic Amortization

THE factors in determining the amortization charge are the base, the salvage value, and the period over which the asset is to be amortized. The salvage value is really a portion of the depreciation base; that is, the amount to be amortized is the base (historical cost, replacement cost, etc.), reduced by the amount which is expected to be received as salvage when the asset is disposed of.

A discussion of the base for amortization[17] and a discussion of the determination of the period over which the asset is to be amortized[18] are contained elsewhere in this chapter.

Base for Amortization

AN INTERESTING cycle of thought can be found in literature on the subject of amortization, and especially in regard to depreciation. Historical cost was the choice of accountants at first, but there was a certain swing toward the use of replacement figures. Now there is a substantial amount of agreement that cost is the most satisfactory basis. The advocates of the cost basis include two distinct types of persons, the conservative, practical, and non-theoretical accountants and the more highly theoretical writers. The former have chosen this method because of its conservatism and its ease in use; the latter have chosen it because of its objectiveness. Perhaps, theory might support the use of an appreciated cost base, but practical

considerations make it necessary that a more objective and measurable base be used.

Historical Cost Base

ACCOUNTANTS, in their quest for objectivity, usually have considered that historical cost is the most suitable base for amortization calculations. However it has been been said that a mere rule-of-thumb application of the historical cost base presents a serious obstacle to the development of the control function of accounting.[19]

The regulations have chosen original cost, adjusted for additions and retirements, and not replacement cost as the basis for recovery[20] and have been supported by several decisions.[21] The basis for depletion, depreciation, and obsolescence is the same as that used for the determination of gain or loss from the sale or other disposition of the asset being amortized.[22]

Replacement Cost Base

THERE has been some advocacy of this method,[23] but it has not received much support among accountants or in Treasury or Board decisions.[24] The usual reason advanced to justify this basis is that management needs depreciation figures computed on replacement cost in order to set its sales prices properly to cover costs and to return a profit. This argument is rather weak; costs do not determine selling prices, except in so far as a business will cease to function if it does not cover its outlays over a period of time.

Another weakness in this argument is that it presupposes that management can not get sufficient information for its replacement and selling policies unless depreciation on replacement cost is included in its accounts. There is no reason why management should not make allowances in its computations for such depreciation in excess of depreciation on original cost if it wishes to include such an item in its computations, but such inclusion can be made outside of its usual income calculations. Depreciation is an accounting for past acquisitions and present holdings and expirations of assets and not for future asset acquisitions.

Stabilized Basis

AN INTERESTING suggestion was made by H. A. Sweeney[25] to alter or adjust depreciation charges to reflect the current level of the purchasing power of the monetary unit. He based most of his argument on a maintenance of capital concept but stated also that the results would be more accurate for income calculation than under other methods. He argued that a proper depreciation method should maintain exactly the capital

invested in the asset being depreciated and that the capital to be maintained was not the asset itself or the original cost of that asset but rather the purchasing power represented by the original cost of the asset. His method requires the re-expression of depreciation, based on historical cost, in terms of the average price level current at the time the depreciation is being figured.

Mr. Sweeney argued that replacement cost was a better basis than historical cost but that it was quite inferior to his method, because replacement cost is designed to maintain mere physical capital rather than purchasing power. His method is very similar to one which uses depreciation based on appreciated cost figures.[26]

Appreciated Cost Base

An appreciated cost basis more closely resembles a reproduction basis than a replacement basis. Reproduction implies an exact substitution at current price levels; replacement implies a substitution of new assets of a slightly different nature but capable of performing the same type of service as the old.

No attempt is made to justify appreciated cost as the proper basis on the ground that it is intended to replace anything or to determine selling prices. This method depends on a prior assumption that unrealized appreciations are proper accrued inclusions in income (theoretically, probably not practically). It is difficult to justify such a base for depreciation to be included in the income calculation unless the appreciation is also included. This does not mean that appreciation offsets depreciation; it means that both the gross income and the deductions therefrom should be stated on a new price level which will reflect the changed purchasing power of the monetary units used in the expression and computation of income.

Article 140 of the 1913 regulations permitted the deduction of depreciation based on appreciated values if the appreciation was included in income.

Period for Amortization

Amortization should be spread over the period during which the asset to be amortized is held for use. This life may be measured in terms of time (hours and years), in terms of output, or a combination of the two.

All things which react on the usable life of the asset must be considered in setting the amortization rate. All or some of the following items, among others, must be taken into consideration: obsolescence, inadequacy, diminution in the raw material supply, normal operating speed, abnormal operations, repair and maintenance policies, overtime, neglect, character-

istics of the labor supply, type of production, climate, accidents, and theoretical capacity.[27]

From a theoretical viewpoint, the above things must all be used in determining the rate. Practically, many of these can not be foretold accurately or at all and must, therefore, be omitted when calculations are made. Both accountants and income tax provisions stress objectivity in the calculation of income and, therefore, limit provisions for amortization to measurable factors which can be foretold.[28]

The regulations long have specified that amortization is to be made over the useful life of the asset being amortized.[29]

Obsolescence

Obsolescence is of extreme importance in the computation of the amortization rate. So-called normal obsolescence is a lessening in potential usable life caused by the normal progress of the industry, inadequacy, change in demand for the product, change in the source of supply, and like things. Its characteristic is that it brings an end to the use-life of an asset possessed by a particular enterprise (or causes that end to approach) in spite of the fact that the asset may not be entirely exhausted and incapable of being used in a physical sense. Abnormal obsolescence is a sudden cessation in use life caused by a decrease in demand for the product, by the invention of a vastly improved asset item, and so forth. There is nothing basic which distinguishes normal from abnormal obsolescence, except that a reasonable estimate may be made in the case of the one, whereas the other comes as a surprise and can not be foretold. Obviously, the latter can not be used in practical calculations of income demanded for accounting and tax purposes, although from a theoretical viewpoint, it has a part in such calculations as great as that obsolescence which is said to be normal.

Nothing was included specifically in the 1913 and 1916 acts regarding obsolescence, but the regulations ruled out, in no uncertain terms, the deductibility of obsolescence until the property was sold or abandoned:

> The deduction to be allowed relates solely to loss due to use, wear and tear, and the matter of obsolescence is not relevant, inasmuch as when the property becomes obsolete a deduction for the loss sustained thereby, representing the difference between the cost and the amount of depreciation previously charged off or which should have been charged off in prior years, will be allowed.[30]

Obsolescence was not allowed before the 1918 act.[31] All of the acts and regulations since and including the 1918 act have permitted the deduction of obsolescence if it is reasonably predictable.[32] Impetus was given to the allowance of obsolescence by the entrance of the United States into the

World War, because special plant facilities had to be erected and recovered during the period of the War. Depreciation allowed under the 1913 and 1916 acts would not have been adequate to cover the asset basis in so short a time, and special permission was given in the 1918 and 1921 provisions for the amortization of the obsolescence of such special wartime facilities.[33] In 1918, obsolescence deductions were introduced for other than wartime facilities also.

A reasonable allowance for obsolescence permitted by the law has been upheld by the Supreme Court.[34] It is not necessary for the taxpayer to sell, scrap, or discontinue the use of tangible property in order to be entitled to an obsolescence deduction.[35]

When the time is reached at which facilities are definitely known to be becoming obsolete due to the adoption of more economical methods by competitors, a deduction for obsolescence may be claimed, prorated over the years between that point and the time of ultimate abandonment.[36] This provision is not theoretically correct, but is a very fair practical method for adjusting incorrect amortization charges for prior periods.

Even in the years in which an amortization charge for obsolescence has been permitted, such amortization has been allowed only if the obsolescence is reasonably predictable. In conformity with this general rule, goodwill may not be amortized, presumably because its life is not considered predictable.[37] The disallowance of a periodic deduction for goodwill obsolescence has been upheld in numerous decisions.[38] This disallowance applies to purchased goodwill, as well as to that which is built up through operations.[39]

Treasury Decision 4055[40] amended Article 163 of Regulations 69, 65, 62, and 45 and followed the decision in the *Red Wing Malting Company* case[41] that periodic obsolescence deductions were limited to property susceptible to exhaustion, wear and tear by use in the business.

Several Supreme Court decisions in public utility rate cases have justified the inclusion of an allowance for obsolescence and inadequacy within the depreciation rate.[42] The Board of Tax Appeals has also decided that the depreciation rate may include an obsolescence rate,[43] but some acountants believe that obsolescence and depreciation should be set up separately.[44] A separation may be desirable from a management point of view but has no effect on income determination.

The recognition of periodic obsolescence deductions has not been of very long standing in accounting procedure, but accountants have come around to the viewpoint that obsolescence is closely akin to depreciation.[45] Agreement is not yet complete, however; there is a substantial body of opinion which favors deferring such obsolescence to future income calculations.[46]

Total Amount of Amortization

The periodic amortization charges must not aggregate more than the base upon which the rate was figured adjusted by the salvage value. Several opinions have been handed down to the effect that depreciation may not be taken after the asset has been amortized down to the salvage value,[47] and the regulations also have held that no additional depreciation may be taken after the cost or other basis has been recovered.[48] The provisions regarding depletion, however, do not conform with this general rule.

Amortization of Particular Items and Miscellaneous Items

The regulations have permitted the capitalization and amortization of successful drawings, models, designs, and experimental work if their useful life can be estimated with reasonable accuracy; but if they have been unsuccessful, they may be charged off at once as a loss.[49] It may be questioned whether an immediate charge-off of unsuccessful items is correct under all circumstances. In some cases, there is a more or less constant amount of unsuccessful items to be incurred in connection with the carrying on of experimental work. Perhaps, some method of spreading this constant amount might be worked out.

Prepaid insurance was held to be subject to amortization,[50] but capitalized advertising expense was not.[51]

There has been no agreement as to the amortization of improvements in the nature of special assessment benefits. In one case it was held that special benefit assessments were not deductible, because they were not used in the business but were only of incidental benefit to it.[52] In other decisions, it was held that private improvements on private ground were subject to amortization deductions.[53]

Leaseholds and Leasehold Improvements

The regulations permit the amortization of the cost of leasehold improvements over the shorter period of the life of the asset or the remaining life of the lease.[54] It has been held that where rentals vary, the allowance for the exhaustion of the leasehold should be spread evenly over the term of the lease without regard to the varying rentals.[55] The regulations have been supported by many decisions and opinions to the effect that leaseholds may be spread over the period of the lease.[56]

Court, Board of Tax Appeals, and other decisions are in accord with the regulations in permitting the cost of leasehold improvements to be spread over the shorter of the lease term or the life of the asset.[57] In many cases, it has been decided that the possible renewal period of a lease

should be ignored in computing the amortization period.[58] In cases where the tenancy is indefinite, the allowance for amortization should be based on the physical life of the asset.[59] The amortization of leasehold improvements over the shorter term of the lease or the asset life is approved by accountants also.[60]

Commissions, Fees, and Expenses Incurred in Negotiating a Lease

IT WAS held in a few cases that such items should be deducted at once when incurred,[61] but most decisions permitted amortization over the term of the lease.[62]

Intangibles—General

THE regulations provide that intangibles of limited duration may be amortized; those incapable of being estimated reasonably may not be amortized against income.[63] This rule is in agreement with court[64] and accounting opinion.[65]

Patents

THE regulations[66] provide that patents or copyrights may be depreciated, although obsolescence is not to be included until the year in which it is said to have occurred. The cost or other basis may be recovered over the period extending from the time of the grant, or from the time of acquisition if acquired otherwise than from the government. The cost or basis includes government fees, costs of drawings, models, attorneys' fees, acquisition price, and similar items. The Board of Tax Appeals and accountants agree that patents and copyrights should be amortized.[67]

Miscellaneous Intangibles

ACCORDING to accounting opinion, franchises may be amortized over the definite period they have to run. If they are perpetual, no practicable amortization is possible.[68]

Trademarks and tradebrands are not subject to amortization, because their useful life is not capable of determination.[69]

There is no unanimity among accountants as to the propriety of amortizing goodwill.[70] Many favor the amortization of goodwill and organization expenses, under the same line of reasoning used to justify depreciation deductions.[71] The following statement is typical of the argument advanced in support of amortization:

> . . . this doctrine of the permanence of good will seems inconsistent with the theory of valuing it as the purchase price of a temporary, terminating annuity. Strict logic requires, at least where the price paid for good will is calculated as representing the present value of a series of excess annual

profits, that it should be written off, as is any other terminable annuity, with reference to the duration of the annuity.[72]

Other writers oppose the amortization of these items because of the difficulties of measurement[73] and the lack of objectivity in determining the amount.[74] Many income tax decisions and opinions agree with this latter accounting opinion that goodwill[75] and organization expenses[76] should not be amortized because of their indefinite duration.[77]

Trademarks, tradenames, tradebrands, newspaper subscription lists, formulas, and rights to receive royalties on copyrighted books have been held not subject to depreciation or obsolescence because of the indefinite duration of their usefulness.[78]

Depreciation—General

THE word depreciation is used frequently in a broad sense in a manner similar to the way amortization is used in this chapter to include depreciation (narrow sense), depletion, and amortization. Depreciation is used in this chapter in its narrow sense to include only decreases due to wear and tear and exhaustion.

Depreciation has elements of both variable and fixed expense in it. A theoretically correct depreciation charge should take both of these elements into consideration. Although depreciation is both fixed and variable to some extent, as a practical matter, it is usually treated as either wholly fixed or wholly variable in any particular case. The cessation of the usable life of long-lived assets is chiefly brought about by decreptitude, obsolescence, and inadequacy; the life of the shorter-lived assets is largely determined by exhaustion through use.

In any given case, it must be determined whether the fixed or variable element is to predominate. The particular depreciation method to be used must be chosen to fit the situation as exactly as possible. In some cases, it may be necessary to determine a rate which combines the variable and fixed elements, or to supplement one with the other. Some depreciation must be charged even during idle periods.[79]

Ever since, and including, the act and regulations of 1913, a reasonable allowance for wear and tear and exhaustion of assets has been deductible if it is in conformity with a consistent and reasonable plan.[80] These provisions do not apply to inventories and land[81] or losses in value of stocks or bonds.[82]

Repairs and Depreciation

REPAIRS do not prevent depreciation.[83] Depreciation is a spreading of the asset base over the usable life and is not necessarily coincident with physical wear and tear or exhaustion. Repairs must be taken into consideration when the amortization rate is set, but they do not make

depreciation charges unnecessary. On the contrary, deductions may be taken for both repairs and depreciation.[84] The above statements are in accord with accounting and income tax provisions.

Appreciation versus Depreciation

SINCE depreciation represents expiration of an asset to conform with its reduced usable life, it is completely different from appreciation, and each should be computed or considered separately from the other. Appreciation is an increase in value; depreciation is not primarily, if at all, an attempt to evaluate assets.

The Board of Tax Appeals has ruled correctly on several occasions that appreciation does not offset depreciation.[85]

The rule has been consistent also in the case of mere market decreases. Such decreases have been held not to constitute depreciation within the meaning of the income tax provisions.[86]

Miscellaneous Depreciation Problems

DEPRECIATION on buildings during the construction period is not deductible as an expense, because the useful life of the building starts when the asset is completed and ready for use.[87] If assets are constructed in sections, depreciation may be computed on those sections as soon as they are completed.[88] There is little point to the computation of depreciation on assets being constructed, because costs and expenses during the construction period are properly capitalized.[89]

The cost of a contract may be written off, under certain conditions,[90] but it may not be amortized if it is of indefinite duration.[91]

Depletion[92]

DEPLETION is a use cost, a diminution in service value, and should be amortized; it is not primarily a loss of exchange value.

Depletion of mines, oil and gas wells, and timber has been subject to amortization under the Federal income tax acts and regulations since 1913.[93]

In 1913, 1916, and 1917, the maximum total depletion permitted was not in excess of the original cost. Depletion computed on cost in those years could not be deducted to an extent greater than a given arbitrary percentage of output or sales.[94]

Depletion has always been permitted to be figured on cost, and, in some years, a more advantageous option has been granted the taxpayer also. In 1918, the base for depletion on cost included development costs as well as the original outlays.

Timber has never been subject to discovery value or percentage depletion but has been restricted to a cost basis.

The revaluation basis has not been recognized for depletion computations,[95] in spite of the fact that the other advantages of discovery value and percentage depletion are permitted the taxpayer.

In the case of oil and gas wells, wages, repairs, and other expenses of exploration, development, and drilling may be deducted at once or capitalized and amortized. This provision applies whether the drilling has been productive or unproductive. A similar rule applies to mines except that only the excess of such expenses over the receipts from the sale of the product may be capitalized.[96]

Percentage Depletion

In 1913, mines, and oil and gas wells were subject to a depletion deduction not to exceed five per cent of the gross value of the output from the property subject to depletion.[97] In 1916 and 1917, they were subject to depletion not to exceed the market value of the product extracted and sold. This increased liberality to the extractive industries coincided with an increased demand for their output for war use.[98]

Strictly speaking, depletion in 1913, 1916, and 1917 was not on a percentage depletion basis. Depletion was figured on cost. The five per cent or other limitations were placed on cost depletion.

There were no comparable provisions in 1918, 1921, and 1924, although discovery value depletion was permitted in those years.

In 1926, oil and gas wells were no longer subject to discovery value depletion but were subjected to percentage depletion. It was felt that simplification would result if an easier method were provided for oil and gas well depletion calculations.[99]

In all cases, at least depletion on cost may be taken. If the taxpayer desires, he may deduct depletion up to 27½ per cent of the gross income derived from the depletable asset, but not in excess of 50 per cent of the net income from that asset, exclusive of depletion. This provision has continued from 1926 to the present time for oil and gas wells.

In 1932, coal, metal, and sulphur mines were subject no longer to discovery value depletion, but taxpayers were privileged to use percentage depletion computations for the first time.[100] Depletion may not exceed five per cent of gross income in the case of coal mines; 15 per cent, in the case of metal mines; and 23 per cent, in the case of sulphur mines. However, the deduction is not to exceed 50 per cent of net income computed without regard to depletion. In every case, the net or gross income used as the percentage base is that income which is derived from the asset subject to the depletion computations. In no case is it necessary for the taxpayer to restrict himself to less depletion than would have been allowed had he based his calculations on cost, except if a binding option has been exercised, as in the case of coal, metal,

and sulphur mines. The provisions regarding coal, metal, and sulphur mines have continued unchanged since 1932. One of the reasons why percentage depletion was instituted for such mines was to circumvent the difficulties of basing computations on cost.[101]

Percentage depletion acts as a very valuable subsidy to the extractive industries:

In other words, having first used up as depletion the cost value of the property and then having used up the discovery value of the property after the oil was discovered, they are now allowed 50 per cent of what they derive from the well each and every year. In the case of a well that was brought in 1915, by 1921, whether oil had been discovered or not, under the law up to that time the cost value would have been entirely covered by the depletion allowance, and no more depletion on that ground would be allowed.[102]

Discovery Value Depletion

In 1918, depletion based on discovery value was introduced into the regulations for mines and gas and oil wells. The provision remained unchanged in 1921 and 1924, except that in the latter year the deduction might not exceed 50 per cent of the net income from the property, instead of 100 per cent, as in 1918 and 1921.

In 1926 and subsequent years, oil and gas wells were not permitted discovery depletion[103] but were permitted a percentage depletion deduction instead, and the 50 per cent limitation was retained.

The use of discovery depletion was intended as a subsidy to encourage and compensate those who prospect for natural resources. It was the opinion of the sponsors of this type of provision that the hard and often unproductive work of prospectors should be compensated for by a decreased tax burden when they make a discovery.[104]

In the 1932 and subsequent regulations, discovery value depletion is limited to mines other than metal, coal, or sulphur mines. These latter mines, as well as oil and gas wells, are subject to percentage depletion instead.

The use of discovery value is limited to properties which were prospected for and discovered by the taxpayer. If the market value at the time of discovery is materially disproportionate to cost, the taxpayer is permitted to value his property at the date of discovery or within thirty days thereafter.

One of the arguments advanced to justify the use of percentage or discovery value depletion is that they are simple and easy to compute.[105]

Many corporations . . . present their financial accounts without the deduction of any charge for depletion. . . . This practice has been followed for a sufficient length of time and by a sufficiently large proportion of those engaged in the mining of nonferrous metals so that it must be considered as an "accepted accounting practice" in the industry.[106]

On the other hand, there are a sufficient number of companies operating

in the industry which make a deduction for depletion in their accounts so that this method must also be considered as "accepted accounting practice."[107]

Another possible solution to the problem would be to treat all income as a return of capital until the cost of the investment has been recovered. From that point on, no depletion would be permitted.

The use of discovery value and percentage depletion has been the subject for much adverse criticism, because they are arbitrary and merely represent a subsidy to particular business interests.[108] If subsidies are warranted, they should be given in another form, outside of the income tax structure. Those who favor such depletion methods base their arguments on the need for special relief to the extractive industries and on simplicity of computation and administration.[109]

Amortization of Expenses, Discounts, or Premium on Issuance of Bonds

The Regulations[110] are in accord with most Board and court decisions[111] and with accounting procedure[112] in their recognition that such items are properly spread over the life of the bonds.

Amortization of Discount or Premium on Bonds Purchased

Articles 135 of the 1913 regulations permitted the amortization over the life of the bonds of the difference between the premium purchase price and the maturity price. Subsequent decisions of the Treasury Department have ruled that such premium is not subject to amortization,[113] since no loss is ascertainable until the bonds are paid off or otherwise disposed of.[114] The court and Board decisions are not consistent on the matter.[115]

Unamortized Balances[116]

Unamortized balances are left when the amortization period is unexpectedly cut short. Unexpectedness is the essential characteristic of this situation; if this were not true, the periodic provisions would have been such that no balance would have remained.

The most common methods for disposing of such balances are:

(a) to write them off to surplus.
   (1) as a loss.
   (2) as a correction of the amortization of past periods.
(b) to write them off to current income.
(c) to set up a deferred charge.
(d) to merge them with new assets acquired.

The method which appears to be most correct is the write-off to surplus or to a special section of the income statement when the discovery is made that no additional amortization can take place. Such

unamortized balances are not associated with the future but are corrections of the amortization of prior periods.[117]

It is sometimes contended that under certain situations such balances benefit the future[118] and should be written off in the future. The following hypothetical situation illustrates that such is not the case. Let us suppose that a certain company sells some of its fixed assets and abandons the rest, although the latter are not fully amortized. Let us also suppose that the company decides merely to hold the cash and to carry on no additional productive operations. It is quite difficult to see how the unamortized asset balance can have anything to do with the future.

In certain cases where an asset is abandoned and similar production is carried along with new assets, there is, perhaps, some slight basis for considering that the future is benefited. When assets are traded in as part of the consideration for new assets, there is a great deal to be said in support of merging the old asset balance in with the new asset balance. The cost of the new asset is really the total of the old asset and the cash or other consideration given.

The Federal income tax provisions require that unamortized balances be written off in the period in which it is discovered that no additional amortization can or will be taken.[119]

Some rather severe criticisms may well be applied to some parts of the Federal income tax treatment of amortization, but it must be admitted that there is no absolute agreement among accountants either on the subject of amortization in all of its ramifications.[120] Many objectionable methods existed before the advent of the income tax; many of them still exist.[121]

The Federal income tax provisions have been built up to a considerable extent from observations of accounting and business practice.[122] Perhaps, to this extent, it might be said that the very existence of the tax provisions regarding depreciation is attributable to accountants. The income tax has, in turn, performed a very valuable service to business in the correct determination of income, by its recognition of amortization and its requirement that it be expressed in the accounts in order to be deductible for tax purposes.[123]

Administration

IN ADDITION to determining whether or not correct theoretical provisions underlie the income tax treatment of amortization, it is also necessary to determine how those provisions are administered.

In the case of errors in computing amortization, it was held by the regulations of the years from 1916 to 1932,[124] inclusive, that the remaining unamortized portion of the asset might be spread over the estimated remaining life. This rule has been modified since 1934.[125] It is now stipulated that the taxpayer may not take advantage of a prior failure

to take adequate depreciation allowable under known facts of prior years. This change is more in agreement with the usual income tax emphasis on periodicity than was the old rule. It was changed in order to prevent tax evasion.[126] Other earlier decisions support the new rule.[127] It has been held, likewise, that excessive depreciation allowed in prior years does not preclude a reasonable deduction in the taxable year, even though the total exceeds the cost of the asset.[128]

A similar rule had been applied for some years previous in regard to the adjustment of the basis of property to determine gain or loss on its disposition. Since 1926, the various acts have given the Commissioner authority to adjust the basis by the amount of depreciation allowable and to reduce the basis where the deduction claimed and allowed in prior years was insufficient. As early as 1923, the Treasury Department ruled the Commissioner could make such an adjustment,[129] and the Board of Tax Appeals and the courts have upheld this opinion many times.[130]

Up to and including the 1932 act, the burden of proof was placed on the taxpayer to justify an amortization deduction, but no amount was to be disallowed unless it was clearly unreasonable.[131] Treasury Decision 4422, issued February 28, 1934, amended the foregoing articles of the regulations of 1921 through 1932. The regulations of 1934, 1936, and 1938 are in accord with Treasury Decision 4422 and provide that the burden of proof is on the taxpayer and that special proof may be required. No longer is it stated that amounts will be allowed unless they are clearly unreasonable.[132]

Congress considered an arbitrary 25 per cent reduction of depreciation deductions in 1934, 1935, and 1936 in order to increase governmental revenue. However, the Treasury Department felt that it was unfair to penalize those who claimed only a fair amount of depreciation.[133] Three principal classes of taxpayers are not required to furnish any special proof.[134] They are:

1. Those whose return shows a net loss after adjustment.
2. Those whose return shows only a reasonable depreciation claim.
3. Those whose return shows depreciation as a very minor factor.

The deduction for depreciation in respect of any depreciable property for any taxable year is limited by Treasury Decision 4422 to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost, or other basis, under the applicable laws and regulations. A taxpayer is not permitted under the law to take advantage, in later years, of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years.[135]

The new policy for 1934 and subsequent years requires the taxpayer to re-estimate the useful life of the assets over which to spread the depreciation. If the depreciation taken in prior years was less than the

amount allowable, the taxpayer loses the right to deduct the deficiency of the prior years.

Treasury Decision 4422 was issued because the government felt that excessive depreciation was being taken and that more revenue could be raised by stricter administration of the law. Some accountants have felt that Treasury Decision 4422 is being administered too strictly and that reasonable provision for obsolescence and other such items which can not be proven specifically are being discriminated against.[136] Perhaps, the impetus given to more adequate methods of accounting for depreciation of plant and equipment by the promulgation of Treasury Decision 4422 justifies the change in administrative methods.[137]

Chapter Summary

THE procedure of amortization has been recognized for Federal income tax purposes since 1913. The straight line method has been favored, but others, notably output methods, have been acceptable.

Historical cost, adjusted for additions and retirements, has been chosen, in general, for the computation of amortization, rather than a replacement or appreciated cost basis. An outstanding exception has been made, however, in the depletion of oil and gas wells and mines. In the case of these extractive industries, however, cost also has been acceptable for depletion purposes and the taxpayer has been allowed depletion at least equal to that which would be computed on cost.[138] Since 1918, the cost base may include development, prospecting, and drilling costs.

For the years of 1913, 1916, and 1917, only depletion on cost was permitted, and even this amount was further restricted to a certain percentage of the gross value of the output of the property. It was five per cent of the gross value of the output in 1913, and 100 per cent of the product extracted and sold in 1916 and 1917.

In 1918, the cost base was departed from for the first time, and discovery depletion was introduced. At this time, depletion was to be based on the value within thirty days of the discovered property. Depletion on such a base was limited to the full net income from the property in 1918 and 1921, and to 50 per cent in 1924. This latter rate has been in force since that time.

Discovery value depletion was permitted for mines and oil and gas wells up to 1926 but in the latter year the privilege was no longer extended to oil and gas wells. A further restriction was made in 1932, and only mines other than those producing coal, metal, or sulphur were given the option to use discovery depletion.

Percentage depletion was introduced for oil and gas wells in 1926, when discovery depletion privileges were taken away. Percentage depletion was extended to coal, metal, and sulphur mines in 1932. Percentage

depletion has always been subject to a limitation based on the net income from the property being depleted. The percentages used are applied against gross income from the property.

In all of the years that these special depletion methods have been in force, they have never been allowed in the case of timber. Timber depletion is based on cost.

The income tax provisions have always contained recognition that recovery must be made over the useful life of the asset being amortized and that all factors which affect that life must be taken into consideration. Among those factors are repairs and obsolescence. Specific recognition has been granted since 1916 to the fact that repairs do not offset depreciation and that a charge may be made for both.

Obsolescence has been permitted to be amortized since 1918, in which year the influence of the World War led to such recognition. Obsolescence is permitted, in general, only for the tangible items; and, even for them, only if obsolescence is reasonably predictable. Emphasis on measurability and predictability has been responsible for the exclusion of intangibles from the right to obsolescence amortization. Abnormal obsolescence and that not permitted to be recognized periodically may be deducted when it is said to be discovered, that is, when the asset is disposed of.

Patents, copyrights, organization expenses, goodwill, and other intangibles may not be amortized for obsolescence. Except for goodwill, since 1913 the other items have been allowed to be depreciated or amortized for other than obsolescence if reasonably accurate estimates can be made. Trademarks, trade names, trade brands, and goodwill are not subject to amortization of any kind because of their indefinite life.

Since 1913 leaseholds have been permitted to be amortized over the lease, and leasehold improvements, over the shorter of the lease or the asset life. Commissions, fees, and other expenses in connection with the negotiation of a lease may be capitalized and written off over the lease period. Since 1916, specific permission has been granted for the amortization of drawings, models, designs, experimental work, and other prepaid expenses. It must not be inferred that the amortization of such things was not permitted before, merely because specific mention was not made in the acts or in the regulations; since, in many cases, certain practices are permitted or encouraged in the everyday administration of the law before they find their way into the acts or regulations.

Premiums, discounts, and expenses connected with the issuance of bonds have been subject to amortization since 1913. There is some question, however, about the status of premiums on the repurchase of bonds; the regulations do not permit the deduction of a periodical amortization of bond premiums.

Amortization for wear and tear (depreciation) has been allowed since

1913. A mere drop in market values is not considered "depreciation"; conversely, appreciation is not permitted to offset depreciation.

Since 1934, there has been much more stringent administration of the amortization provisions of the law, particularly of the depreciation provisions. Even prior to 1934, those in charge of creating and administering the income tax provisions felt that excessive depreciation was being taken. In 1934, stricter periodicity was observed, and taxpayers were not permitted to gain from previous errors in depreciation. However, similar provisions can be found as far back as 1923, in connection with the adjustment of the basis of assets by the amount of allowable depreciation rather than allowed depreciation.

In 1934 also, a heavier burden of proof was placed on the taxpayer, although the Bureau showed an intention not to invoke these provisions unless it thought the taxpayer was manipulating its depreciation figures. Treasury Decision 4422 and subsequent regulations specify that depreciation estimates shall be revised every year, if necessary, to reflect new information regarding the condition and anticipated life of the assets.

The general comment might be made that income tax provisions for amortization are largely in accord with accounting procedures and have remained comparatively unchanged since the early days of the income tax law. Some criticisms might be made of the law, but about the same criticisms apply to accounting procedure on the matter. The business world and accountants owe a debt to the income tax for its services in bringing to the attention of businessmen the importance and nature of amortization of assets. For tax purposes it has been required that amortization entries be recorded on the books in order to be deductible. This requirement was the incentive needed to improve depreciation and other amortization methods.

In general, stress has been placed on objectivity and fair measurement in amortization computations, but this emphasis on objectivity is thrown overboard in the depletion provisions. It may be, however, that percentage depletion is an attempt to use uniform arbitrary methods in order to avoid the lack of objectivity which is generally associated with depletion calculations. In general, the income tax permits amortization provisions to recover only cost as the maximum, but the use of discovery depletion and, especially, percentage depletion represents a wide deviation from the cost recovery policy.

There is little to find fault with in the theoretical foundation for income tax provisions concerning amortization, with the important exception that the depletion procedures are unsatisfactory.

CHAPTER X

COST OF GOODS SOLD—INVENTORIES

INVENTORIES ARE OF PRIME IMPORTANCE in that they are the residue after some of the goods available for sale have been disposed of. Our interest in inventories for income determination purposes is, in reality, an interest in the cost of goods sold. If the cost of goods sold is to be arrived at indirectly by deducting the inventory from the goods available for sale, it is important that the inventory be stated at an amount which will leave a correct cost of sales figure.

There is no uniformity among the general bases for stating inventories, however. Even the general bases are further subdivided into a number of different methods for inventory determination. Perhaps it would be advisable not to insist on any one method for stating inventories, but to vary the methods according to conditions in particular industries.

Four major common bases of inventory valuation are cost, replacement cost, lower of cost or market, and base-stock. In addition to the ordinary methods of determining cost, there are the following ones applicable to special situations: apportioned costs, farm-sales, and retail inventory. After cost has been determined there are several methods for distributing it; they are: actual identification, weighted average, moving average, first-in, first-out, and last-in, first-out.

> To form an entirely satisfactory basis for the imposition of income taxes the accounts must reflect the full, true, economic position of the taxpayer; and in so far as arbitrary rules of inventory valuation operate to build up hidden reserves, or other accounting practices tend to befog the picture, they must ultimately be eliminated, since they have no place in truly scientific accounting.[1]

Recognition of Need for Inventories

THERE was no specific provision for inventories in the act of 1913, but the regulations contained such recognition and have continued to do so ever since.[2] The 1916 act[3] adopted the 1913 inventory regulations.

Recognition of Accounting Methods

SPECIFIC authority has been given the Commissioner to prescribe any inventory basis which conforms as much as possible to the best accounting practices in a given trade or business and which clearly reflects income.[4] This provision meets with the approval of accountants, but Congress and the Bureau of Internal Revenue must exercise care to be

sure that the income tax acts do not adopt any erroneous practices merely because they are commonly used in any given industry. The Commissioner's regulations have also contained specific reference to the use of methods commonly used in a given industry and which reflect income.[5] The Board of Tax Appeals has also ruled that an inventory is to be valued along the lines suggested above.[6]

Consistency

THE regulations have always stated that the consistent use of any one method was of more importance than the particular method chosen.[7] This opinion has met with the approval of the Board,[8] the courts,[9] and of accountants,[10] although consistency is not sufficient to offset the use of methods which do not clearly reflect income.[11] In the long run, the particular method used will not change the total income over the life of the enterprise. A difference in taxation would result, however, because of changes in tax rates and methods of making computations in the various years.

Book Inventories

BOOK inventories have been approved by the Board[12] and, since 1913, by the regulations.[13] However, actual count is preferred and is recommended to supplement and verify the perpetual inventory figures.

Inclusion of Goods in Inventory

THE Federal income tax provisions[14] are quite similar to accounting procedures in this matter. Goods held under contract of sale (future, not consummated sales) and not segregated for the purchaser and goods consigned out should be included in the inventory. Any stock in transit may be included only if title remains with the taxpayer. Merchandise shipped on approval should be included in the shippers inventory until it is accepted.[15]

Damages and Other Allowable Inventory Losses

THE regulations have contained recognition that inventories may be stated at a lower price and current income reduced where goods are unsalable at the normal price because of damage, imperfections, obsolescence, loss, and so forth. They may be priced at the selling price less estimated cost of selling, but the price should not be in excess of cost and not be less than scrap value.[16] This rule conforms with accounting procedure[17] and Board of Tax Appeals[18] and court decisions.[19]

An arbitrary percentage reduction for obsolete goods and broken lots

has been disallowed by the Board of Tax Appeals;[20] reductions must be made on specific items.

Reserve for Estimated Depreciation or Future Price Changes

THE regulations from 1921 to 1938, inclusive, specifically have forbidden reductions in inventory prices, based upon estimated percentages for depreciation or future price decreases.[21]

Among such forbidden practices, the Board of Tax Appeals has included arbitrary reserves for: obsolete goods and broken lots,[22] discounts,[23] flat reductions of cost price,[24] and future market losses.[25]

Reserves for future inventory declines are usually considered surplus reserves.

Miscellaneous Procedures

THE regulations prohibit the omission of parts of an inventory and the statement of work in process at an arbitrary, nominal figure.[26]

Bases for Inventory Pricing

THE regulations[27] and Board[28] have provided that either (1) cost or (2) the lower of cost or market may be used for inventory pricing, but that the base chosen must be applied consistently to each item in the inventory.

Cost Basis

COST (i.e., purchase or production price) appears to be the best basis for inventories if a sales or similar rule is used to mark the existence of income.[29] Objection sometimes is advanced that the use of cost inventories may not disclose properly financial condition when large inventories are held at a cost greatly different from the market price.[30]

The use of cost involves two principal problems: (1) the determination of the things which should be included in or excluded from cost, and (2) the distribution of ascertained cost between the inventory and the cost of sales. There is more disagreement and difficulty associated with the second than with the first problem.

Cost Determination

THE regulations permit the deduction of trade discounts from and the addition of transportation inward and similar expenditures to cost,[31] and the Board of Tax Appeals has agreed.[32] The courts have held that the Commissioner may remove from his regulations such permission for trade discounts.[33]

Cash discounts may be deducted or may be ignored in determining

inventory; the only requirement is that the taxpayer consistently follow his usual procedure.[34] This provision has been upheld many times by Board and other decisions.[35]

Selling expenses, interest on invested capital, and profit distributions are not to be included in cost according to the regulations[36] and according to common accounting procedure. Some accountants, however, feel that if some practical method can be devised, administration and selling costs should be inventoried if they are associated with unsold goods.[37]

The regulations have granted recognition, as have accountants,[38] to the fact that certain industries have peculiar problems which demand special treatment. When such a situation exists, the taxpayer may use the methods and basis considered a general trade practice.[39]

Among such special methods permitted are the retail inventory method,[40] the farm-price method,[41] and the apportioned cost method.[42] The retail inventory method prescribed by the regulations is the same as that generally recognized by accountants.[43]

The farm-sales method has been permitted by the regulations[44] when it is necessary. This method is sometimes known as the cash realizable method and requires that the current market price be reduced by the estimated cost of marketing and collection to a figure which approaches cost. It has the approval of accountants when conditions are such that other methods can not be used successfully.[45] The chief objection advanced is that gains are taken up prior to sale.[46]

In certain industries, such as mining, real estate, lumber, and manufacturing, joint or combined costs can be determined for large portions of the inventory but not for subdivisions of those portions. In order that inventory prices and cost of goods sold figures can be determined, the joint-cost must be allocated. The resulting figures are not true costs, of course, but are a fairly satisfactory estimate.

The method approved by accountants[47] and the regulations[48] for allocating joint-costs is the relative sales value method. To arrive at the inventory figure the total cost is multiplied by the fraction that the sales price of the inventory bears to the sales price of the total goods which were available for sale.

Cost Distribution

PERHAPS the most widely used cost method for allocating part of the inventory to the goods sold is the first-in, first-out method. The assumption underlying it is that the oldest goods are the first removed. This assumption conforms with fact in some industries and contradicts it in others.

This method approaches the replacement cost basis, in that most

recent purchase prices are left in the inventory. It directly opposes the theory that most recent costs should be in the cost of goods sold figure.[49]

Some of the widespread use of this method can be traced to its advocacy for income tax purposes by the regulations,[50] in the case of intermingled goods where actual identification (most desired by the regulations) is not possible.

In 1918, Regulation 45[51] permitted lumber manufacturers to use the average cost method for determining inventory, and the Board concurred,[52] but this provision was omitted afterward, and average methods have not been allowed since. The Board has upheld the Commissioner's disallowance of the average cost method.[53] In 1920, an exception was made in favor of the tobacco industry.[54]

An arithmetic or weighted average is not a satisfactory method for determining inventory. However, a moving average appears to be the most theoretically correct. A vendor does not sell specifically the first or the last goods acquired; he sells a portion of his entire inventory on hand at the time of sale.

The last-in, first-out method for determining inventory has aims and results similar to those of the base-stock method.[55] However, the last-in, first-out method is a cost method and goes less far than does the base-stock method. The last-in, first-out method has received some recent favor among accountants if used under special conditions and in certain industries.[56]

It is applicable to a few restricted types of industries only, those which fabricate basic raw materials in long-period, continuous processes.[57] In industries of this sort, large sums are tied up in inventories, and if the first-in, first-out method is used in periods of rising prices, large inventories and operating profits are shown in the spread between the cost of sales and the sales.

A further definite requirement for its use is that the industry be one in which raw materials costs largely determine and fluctuate with the selling prices. The chief argument for this method is that the sales and costs should be matched on the same price level.[58] Unless such matching is accomplished, it is asserted, market influence and operating results are hopelessly mixed; but the same thing could be said of any income figures not adjusted for price level changes by index number or other devices.

It would seem, however, that such industries should recognize in other ways that they are subject to gains or losses from market variations and not try to cover them up with questionable matching procedures.[59] In many of the industries to which the last-in, first-out method is said to apply, there are established spot and future markets in which hedging can be carried on to counterbalance non-operating gains or losses, if

desired. Change in the income tax to include the last-in, first-out method has been advocated to aid industries which can not protect themselves by hedging.

The objections advanced to showing higher valuations for inventories in periods of rising prices appear to be based on a cash concept of income; the criticism is that the increased price is stored in inventory and is not reflected in increased cash.[60]

The base-stock method has never been allowed for Federal income tax purposes,[61] and the related last-in, first-out basis has been recognized only since 1938. Section 22(d) of the 1938 act was new and was based on Treasury Decision 4865.[62] The latter has been superseded by Articles 22(d)-1 to 22(d)-4.

The gist of the 1938 provisions[63] is that they are applicable only to those whose principal business is (a) smelting nonferrous ores or concentrates, or refining nonferrous metals, or both; or (b) producing brass, copper products, or brass products up to a certain stage of production. This provision was limited to raw materials inventories and did not extend to goods in process or finished goods. It was limited specifically to items so intermingled that they could not be identified with specific invoices.

Tanners, whose principal business was tanning hides or skins, were given the privilege of using the method for raw materials (including those in goods in process and in finished goods) if the materials were so intermingled that they were not capable of being identified with specific invoices.

The use of the last-in, first-out method was limited further to inventories priced on a cost basis.

Senate discussion[64] regarding this 1938 provision indicated that it was suggested in order to permit the use of a recognized trade practice. The overall income for a long period of time would not be affected by the use of this method, but a more even distribution for tax purposes would be accomplished. In 1936, the Senate Finance Committee suggested that the Treasury take care of the matter in its regulations, but it failed to do so in 1936, 1937, and the early part of 1938. When the 1938 provision was inserted, it was acknowledged that it was only a start in the matter and that revision would be necessary.

The chief objection advanced to the 1938 provision was that it did not include enough industries of a similar nature[65] such as manufacturers, fabricators, and converters of rope and cordage, advanced processors of nonferrous metals, oil, rubber, textiles, leather, chemicals, lead, copper, and other metals. The best explanation for the exclusion of many of these is that the Treasury Department desired to experiment in easy stages with such a provision.[66]

Section 219 of the 1939 act[67] allowed any taxpayer to use this method

so long as he has used it in his financial statements prepared for other purposes besides taxation and has properly filed an application with the Commissioner. The last-in, first-out method may be used only in connection with the cost basis. The requirement that the goods be so intermingled as to be incapable of identification is no longer included.

Lower of Cost or Market Basis

THE lower of cost or market price is the alternative rule (the other is cost) permitted by the regulations for Federal income tax calculations.[68] It is, perhaps, the most widely used of all inventory calculation methods.[69]

Many accountants have expressed their support of this method for practical purposes,[70] but even these persons, among others, indicate that its chief virtue is conservatism[71] and that it has many weaknesses.[72]

Some accountants have been considerably outspoken against this method and have characterized it as an inconsistent and illogical rule-of-thumb method.[73]

The lower of cost or market rule is not synchronized with the general test of sales as the point of realization and receives most of its criticism from the fact that it recognizes market values only if they are below cost. It is conservative as far as the balance sheet and the net worth of an enterprise at a given date are concerned; but it is not truly conservative in that it must be used as the starting point for cost of sales figures for the subsequent period. It is not consistent, because cost may be used at one time for an item, and market, at another time.[74]

The lower of cost or market rule did not appear in the Federal income tax provisions until December 19, 1917.[75] This method for computation has been upheld by many decisions of the Treasury Department,[76] the Board of Tax Appeals,[77] and the courts.[78] To arrive at market price, cost may not be reduced by a straight estimated percentage.[79]

The lower of cost or market rule marks a deviation from the general attitude of income tax provisions toward the objectivity of transactions. The usual income tax rules are pointed toward the measurement of gains or losses only upon sales or exchanges and are based on the use of consistency. Prior to 1917, cost was the basis required.

It appears that the permission granted for the use of the lower of cost or market price was a step in the wrong direction. It is rather interesting to notice that this is a case in which income tax authorities adopted a questionable rule at the behest of accountants and businessmen. It is ironical to notice also that accountants now are questioning the very validity of that rule.

William A. Paton accounts for the introduction of this rule into the income tax, as follows:

An outstanding example of unsound and non-conservative practice masquerading under the guise of sainted conservatism is the "cost or market whichever is the lower" rule of inventory valuation. . . . This practice, imported from Europe, did not make marked headway in this country until the advent of the Federal income-tax program. Originally, in fact, it was not officially recognized as a sound practice by the United States Treasury Department. The early American enthusiasm for the device—among trade associations, business managements, and corporation accountants—was not a tribute to the merits of the scheme as a worthwhile accounting mechanism, designed "by accountants of larger mold" for the purpose of emphasizing "the broader aspects" and "indicating the unfavorable possibilities" of the future, but as an immediate method of reducing taxable income. (And some concerns paid heavily for making the shift just before a higher level of tax rates appeared.) In other words, the wide use of the rule in the United States is not as time honored as many think, and it waxed on account of considerations far removed from the development of sound accounting.[80]

Replacement Cost Basis

THE replacement basis has not been permitted for Federal income tax purposes, but it has had some advocates among accountants.[81]

It gives results similar to that of a cost basis under the first-in, first-out method.[82] Some points advanced in its favor are that it is logical, uses only one price, has a significant relationship to selling prices, is easy to use, shows the correct financial condition, and separates operating and market profits.[83] The chief argument against the replacement basis is that it anticipates profits.[84]

Base Stock or Normal Inventory Basis

THE method of constant price or nominal value for a so-called normal quantity has never been sanctioned for income tax use.[85] The assumption underlying this basis is that a minimum stock must be maintained at all times and is similar to a fixed asset. Any units over or under the minimum are multiplied by the current prices and are added to or subtracted from the base stock. The purpose and theory underlying this method are similar to those which underlie the "last-in, first-out" method.[86]

This method is not widely used but has the support of some accountants.[87]

Chapter Summary

A NUMBER of inventory problems have not been discussed in this chapter, because they do not fall within the scope of this study. Some of the subjects not discussed are: hedging, changes from a cash to an accrual basis, purchase commitments, special problems of cotton and grain dealers, and of dealers in securities, the determination of "market," and so forth. Other matters of interest allied to the subject of inventories

have been taken up in preceding chapters and were, therefore, not discussed in this chapter.

The outstanding characteristic of the Federal income tax provisions regarding inventories is their relative permanency; there has been little change in the acts and regulations since 1913, 1916, and 1918. The acts and regulations have been quite in accord with Board, court, and accounting opinions in most inventory matters. Many specific references to inventory provisions did not arise before 1918, because the acts and regulations were not highly developed at that time. But in most cases, the provisions of 1918 reflect the opinions held in prior years.

The necessity for the use of inventories (including book inventories) was recognized in 1913. Accounting methods for treating inventories (including special methods for particular and peculiar industries) were granted recognition in 1918 and have been continued in all succeeding years.

The accountant's rules regarding the title of goods to be included in the inventory and his insistence on the consistent use of any given inventory method have been reflected in the legal provisions since 1918. Reductions for damages, theft, or other factors which reduce the salability of goods were permitted in 1916, along the same general lines as specified by general accounting procedure. Flat percentage reductions for damages, estimated depreciation, future price changes, etc., were disallowed specifically in 1921. This provision is in accord, in a general way, with accounting methodology, because such disallowed reductions are more in the nature of surplus allocations than of operating reductions. This statement is particularly true if adherence to objective realization is insisted upon.

The Federal income tax provisions have permitted the cost or the lower of cost or market bases to be used for inventories since 1918. Prior to that time, insistence was made on the cost basis only. A cost basis is preferable to the lower of cost or market basis and is more in accord with the general emphasis on objectivity, which is encountered so frequently in the income tax. The income tax was more logical in this matter before 1918, but the pressure brought by accountants and businessmen caused the inclusion in the tax system of this provision.

The market basis and the base-stock basis have both been disallowed for Federal income tax purposes.

The income tax provisions for determining cost are very similar to those of accounting. Special methods, such as the farm price, apportioned cost, and retail inventory methods, have been permitted since 1918 for tax purposes. These special methods are used in about the same way and under about the same circumstances as would be true under accounting rules.

After cost has been determined, there still exists the problem of apportioning it between the goods sold and the goods remaining on hand. Federal income tax provisions indicate a preference for actual identification of the goods sold with their acquisition or production price. The second choice permitted is the first-in, first-out method. This is most widely used in practice but frequently is little more than a rule-of-thumb method.

A third choice was permitted certain industries in 1938 and was extended to all in 1939. It is the last-in, first-out method. Only grudging permission has been accorded this method under the income tax; a like comment may be made appropriately also regarding the acceptance of this method by the accounting profession.

Average inventory methods are not permitted under the Federal income tax system. In 1918, an average was permitted for lumber manufacturers only, in the case of joint costs. Some average methods are not satisfactory, but the elimination of average methods eliminates, perhaps, the most theoretically correct method of all, the moving average.

Criticism of the Federal income tax treatment of inventories is equivalent to a criticism of accounting and other inventory methods, because the income tax provisions conform closely with ordinary procedures and methods for pricing inventories.

CHAPTER XI

AN INCOME CONCEPT

IT IS CLEAR THAT an indirect but heavy burden growing out of taxation is that of preparing a great number of tax and other complicated reports for various governmental bodies.[1] For this reason, if for no other, income tax provisions should conform as closely as possible to good business and accounting procedure.[2] But can this be accomplished?

It has been suggested frequently that some sort of Federal commission on accounting and tax matters be formed to coordinate the demands of the multitudinous governmental units with each other and with proper business and accounting provisions for accounting records and income determination.[3]

In order to be effective and useful, such a committee would have to be chosen on a non-partisan, scientific basis. It would have to be composed of businessmen, lawyers, accountants, tax experts, and government administrators. An ideal system of standards for income determination could then be set up and allowable deviations therefrom could be determined. Care would have to be exercised not to make these standards too detailed nor too restrictive. Much of the difficulty with the Federal income tax has been that it has provided too minutely for detailed procedures. The result has been that inconsistencies have arisen between the various income tax provisions themselves and between such provisions and accounting and business procedures. Only the fundamental and broad outlines should be laid down. Individual procedures would not need to be uniform but would be required to remain within the broad structure outlined.

Litigation which might arise out of income tax situations could be settled on a case basis, as is done in issues arising under the jurisdiction of the Securities and Exchange Commission. Preliminary advisory opinions could be furnished a taxpayer regarding contemplated actions in order to eliminate the objection that a very general law might be too vague and uncertain in its effect on the taxpayer's tax liability and the conduct of his business.

In order that the work of such a committee might be carried on, it is necessary that there be constructed a system of standards for income determination and the acceptable deviations therefrom. A considerable amount of work has been done already to construct this fundamental base, but there is no generally accepted system yet. Against such a

system of standards must be compared the existing practical accounting methods and the Federal income tax concept of income.

A comparison of the Federal income tax concept of income with a system of standards depends not only upon a determination of such standards but also upon the determination of the income tax concept of income. This study has been an historical and theoretical examination of detailed income tax provisions. From this has been distilled the income tax concept of income. This concept is based upon statutory provisions; upon Bureau of Internal Revenue regulations, opinions, and decisions; upon Board of Tax Appeals decisions; and upon court rulings. Out of this has come the conviction that the basis for the needed reforms in the methods of determining taxable income lies in reconciliation of two views regarding the concept of income.

A satisfactory broad concept of income is: the net increase of economic power from all sources, excluding additional investments and withdrawals. This concept must be modified for accounting and tax purposes to take into consideration difficulties of measurement and the necessity for objectivity. A suitable concept of income for tax and accounting uses is: the net realized increase of economic power, from all sources, measured in terms of money, between two points of time, excluding additional investments and withdrawals.

The analysis of the income tax treatment of each of these elements of a satisfactory definition is given in the following summary.

Net Income Concept

THE tax was intended to conform with the popular conception of income held at the time the tax was introduced in 1913. Probably the common concept of income was a net income concept. All of the acts from 1913 to 1938 have recognized that net income, computed by accounting methods, is to be determined and taxed. Unfortunately, it has also been provided that such determination is to be made subject to deviations considered necessary by Congress or the Commissioner. The statutes and the Supreme Court have held substantially that the tax is to be on gross income, reduced only by the things Congress may allow to be deducted.

Ordinary and necessary business expenses, repairs, rentals, traveling expense, fees, compensation paid, pensions (restricted in certain years), amortized amounts of long-lived assets, and cost of goods sold are deductible items.

The cost of sales is required to be computed in much the same general manner as it is done by accountants. The use of inventories has always been recognized under the income tax acts, and specific recognition of accounting methods (especially in peculiar industries) was granted in

1918. Deduction may be made from the inventory figure for reductions in salability of goods, caused by damages, loss, theft, etc. Flat percentage reductions for such items and for price decreases are not permitted.

Prior to 1918, only the historical cost basis for inventories was permitted. In 1918 and since that time, the basis of lower of cost or market has been permitted, due, no doubt, to the pressure exerted by accountants and businessmen to have it included in the law. This basis is inconsistent with the disallowance of price reductions and with the general emphasis placed upon objective measurement. Market price, base stock or normal inventory, and appreciated cost are not permissible bases.

The provisions for determination of cost conform closely with those of accounting practice. Special methods, such as the farm price, retail inventory, and apportioned cost methods, are permitted for certain industries, in accordance with trade and accounting practice.

After cost has been determined, there still remains the problem of apportioning it against gross revenue. The method favored for income tax use is actual identification of specific goods sold. The second choice is the first-in, first-out method. In 1938, grudging permission was given to allow the last-in, first-out method to a very few industries and under certain restricted circumstances. This permission was extended to all in 1939, subject to certain restrictions. The moving average method, perhaps the most theoretically correct method, has been denied by the income tax provisions. None of the average methods has been permitted, except in a few very rare cases.

The chief characteristics of the tax provisions for inventories is their relative permanency and their emphasis on consistency.

There is little with which to find fault in the tax provisions regarding allowable deductions. There are other provisions, regarding non-deductible items, however, which well may be criticized.

Prior to the 1918 act, corporations were denied a deduction for life insurance premiums paid. Since that time, a corporation is permitted such deductions, provided it is not the beneficiary.

Before 1935, corporations were denied a deduction for purely charitable contributions. Since that time these have been permitted to the extent of five per cent of the net taxable income computed without reference to such contributions. In all years, a deduction has been allowed if the gift could be proved to be a necessary and ordinary business expense.

Before the 1918 act, interest was deductible, but subject to an arbitrary limitation. In all of the acts since that time, it has been fully deductible. Two important exceptions have been made, however. Neither interest on a company's own investiment nor interest paid to acquire or carry tax-exempt securities is deductible.

Taxes are items which are partly deductible and partly non-deductible,

but in general are deductible. They include licenses, Federal duties, excises, stamp taxes, and sales taxes (under certain circumstances).

Since 1918, the taxpayer has been given the option of deducting from income or claiming as a credit against the tax any war, excess profits, and income taxes paid to a foreign country or to United States possessions. This general deduction has not been permitted for like taxes paid to the United States, however. In 1913 and 1916, these latter taxes were fully deductible, but an optional credit against the income tax was not permitted. From 1917 to 1936, inclusive, no deduction has been permitted, although a credit was permitted in the acts from 1917 to 1921, inclusive. There has been a very slight relaxation of this rule in 1936 and 1938.

The deduction of capital losses has been a subject for artificial limitation also. In 1916 and 1917, they were deductible to the extent that there were capital gains. For 1918 to 1932, inclusive, there were no restrictions; but in the years from 1934 to 1938, they were permitted only to the extent of $2,000 over and above the capital gains. In 1939, long-term capital losses were allowed in full, but short-term capital losses were only permitted to offset short-term capital gains (although a partial carry-over was permitted).

Certain items are completely non-deductible. Charges to surplus for reserves, dividends declared or paid, and capital expenditures are deductible neither for accounting nor tax purposes. Certain additional items are not deductible for tax purposes; they are: lobbying and campaign expenses, non-civil fines and penalties, and expenses to acquire tax-free income. This latter exclusion has been relaxed, inconsistently, in favor of expenses (other than interest) incurred to obtain tax-exempt interest income.

Local benefit assessments, sinking fund contributions, organization expenses, costs of perfecting title, experimental and development expenses, commissions in connection with the purchase of long-lived assets, carrying charges on real estate, and the cost of razing old buildings built on land purchased with the destruction in mind are examples of capital expenditures not deductible when incurred, under either accounting or tax procedure.

Deduction provisions generally have followed accounting procedures except that arbitrary limitations and non-deductible items have been specified.

The Federal income tax is founded upon a limited net concept of income.

Realized Increase

THE use of periodic calculations requires that it be determined within what period gross income may be said to have occurred. The time at

which income is to be recognized and measured is the point of so-called realization.

Difficulties of measurement and the need for objectivity in income determination for tax and accounting use have caused the accrual of income to be abandoned in some cases in favor of a given moment of time as the place at which income is to be recognized and measured. The tax and accounting rules are similar in their emphasis on the use of a closed and completed transaction as the point for income realization. So-called unearned increments or decrements in value are ignored and are not taken up as income determination items until the asset is disposed of or abandoned.

The sale is usually chosen as the event which marks the point of realization and measurement. That it is not an altogether satisfactory base has been recognized in the special tax and accounting provisions for bad debts, maintenance commitments, average income proposals, short sales, long-term contracts, installment sales, c.o.d. sales, approval sales, cost-plus contracts, production to order arrangements, and farm-price inventories. Generally, the income tax and accountants make relatively little use of legal rules regarding title.

Specific rules have been set up regarding the point at which income or deductions should be recognized for other than normal operating items.

In 1918, leasehold improvements were considered income to the lessor at the time of completion. In 1921, the lessor could take up the income in the year of completion or spread it over the period of the lease. The trend in the last several years has been to defer the income inclusion until the time of disposal of the asset, but to permit it to be spread over the lease if the improvement is required and is equivalent to a rental charge.

A fixed moment of time has been specified for the recognition of gain or loss on the following items: repossessions of real estate sold on deferred payment plans; sale of patents, copyrights, goodwill, and installment obligations; judgments; bad debt recoveries; worthless stock; loss of useful value of assets; and dividends receivable.

A class of tax-free exchanges has been set up as an exception to the usual rules regarding the recognition of income. In connection with these exchanges, it is felt that objective measurement is not possible, that accurate measurement is not easy of accomplishment, that the burden on the taxpayer should not be made too heavy, and that it would be better to postpone the recognition of income until a later, objective event takes place.

This class of exchanges was not included prior to 1918. It has not been modified substantially in recent years, except for a tightening up in

places to prevent tax avoidance. Within this general group fall transfers, following involuntary conversion, to controlled corporations, for property of like kind or use, and in conformity with orders of the Securities and Exchange Commission.

The cash, satisfaction, and dissolution bases for income determination have been given scant recognition in either tax or accounting provisions for the calculation of corporation income.

Many of the difficulties in connection with the determination of income for tax or accounting use are caused by the inconsistent use of both an accrual basis and a closed transaction basis for recognizing income. Which is to be used appears to depend upon the certainty of the occurrence of an event and the measurability of the result.

From All Sources

Gross income includes income from all sources, for Federal income tax computations. This sweeping generalization must be modified to the extent that certain specific items are tax-exempt.

Business income, leased property income, dividends, some interest, leasehold improvements (to lessor), and profit or loss on non-recurring exchanges, sales, or other asset dispositions (except for certain tax-free exchanges) are all includible in gross income.

The proceeds of life insurance policies are not taxable, but the interest on such proceeds is taxable. All interest, in general, is taxable, but an exclusion has been made in connection with interest received from obligations of states, subdivisions of states, and United States possessions. Interest on postal savings accounts is tax-free also. The interest from certain United States obligations and those of government corporations is either partially or completely tax-free. Credits against income for certain of these are permitted in order to make them partially tax exempt.

In some years, a certain minimum of income was allowed to go untaxed, but this provision is no longer a part of our system.

Dividends included in the purchase price of securities purchased are treated as part of taxable income when received, when, in fact, they are merely a return of capital.

Intercorporate dividends were fully taxable in 1913, tax free from 1917 to 1934, subject to a tax on ten per cent of such dividends in 1935, and subject to a tax on fifteen per cent of such dividends in the 1936 and 1938 acts.

Prior to the 1921 act, stock dividends were considered income to the recipient under the statutes then in force. From 1921 to 1934, inclusive, share dividends were excluded from income, on the authority of the court decision in *Eisner v. Macomber*. It was felt that this case had been

applied too broadly, however, and the acts of 1936 and 1938 specified that share dividends were to be taxed if they resulted in a change in the interest of the recipient in the corporation.

Before 1938, property sold to a shareholder by a corporation below the fair market value of that property gave rise to taxable income to the shareholder. The rule was modified and improved in 1938 by the stipulation that such a transaction gave rise to taxable income only if it was equivalent to a distribution of earnings or to compensation for services.

Gain or loss by a corporation resulting from transactions in its own reacquired shares were to be considered in determining income under the 1916 and 1917 acts, but not in those of the years from 1918 to 1932, inclusive. They were to be included, according to the acts of 1934, 1936, and 1938, if the transactions were entered into for profit and were substantially equivalent to transactions in shares of another corporation. This same trend has been discernible also in court and accounting opinions.

In the years from 1918 to 1932, inclusive, forgiveness of debt did not result in taxable income for the debtor. In 1934, 1936, and 1938, such forgiveness has been considered income for tax purposes; although in the latter two years, those in financial difficulty have been given the privilege of excluding such items under certain circumstances.

No special tax treatment has been accorded capital gains and losses of corporations, other than limitation provisions on such losses. Special tax rates do not apply as in the case of individuals. In the years from 1921 to and including 1934, capital assets were limited to those held over two years. In 1936, this holding period was abolished. In all of the years, the classification of capital assets has not included inventories; and in 1938, depreciable assets were also excluded.

Certain other items are excluded from gross income, because they are considered correctly as capital contributions. They are: the proceeds from the original issuance of shares, donations by shareholders, and forgiveness of debts owed by the corporation to shareholders.

There has been relatively little change in most gross income provisions throughout the years the income tax has been in force. Some of the more questionable provisions have been subject to change, however. Artificial exclusion of certain items is the chief objectionable feature of the gross income provisions.

The Federal income tax is a tax designed to include all income, but it has been made subject to several exceptions.

Economic Power—Terms of Money

For practical computations, it is necessary that income be expressed in money. Although the value of money is not uniform in different income

determination periods, no attempt is made in tax and generally used accounting procedures to adjust the monetary unit to its current purchasing power.

Between Two Points of Time

FUNDAMENTALLY, income is a long-range concept. It covers a period from the formation of an income producing enterprise to its dissolution. The extremely long life of most enterprises requires that income calculations be broken up into shorter periods for tax and accounting purposes. This breakdown of the long life causes periodicity to assume extreme importance and is responsible for most of the problems of accounting and of income calculation. The amortization of assets, the differentiation between capital and revenue expenditures, accruals and deferments, reserves, the differentiation between recurring and non-recurring items, realization, and the carrying over of losses and the averaging of income are the principal problems of income determination and of accounting; and all are traceable to the introduction of arbitrary short-term periods into the income calculation.

The measurement of income for short periods requires that all related gross income and deduction items be brought into the same arbitrary period. All of the various procedures enumerated above may be considered to be represented by the all-inclusive term of matching. It is the foundation for the so-called accrual basis of accounting.

Matching has always been a part of the modern income tax system. The 1909 act was written on a cash basis but aroused so much opposition that it was enforced on an accrual basis. Beginning with the 1913 act, accrual accounting definitely has been a part of the Federal income tax law.

The income tax idea of the nature of accrual methods has not always coincided with that of accountants. Up to about 1925, the legal idea of accruing was tied up with the idea of the existence of a legal claim, of coming due. In 1926, the Supreme Court recognized that the accounting concept of accrual was superior to the existing legal idea. The Board of Tax Appeals shares this better view now, but, as recently as 1939, was forced to reverse decisions of the Bureau of Internal Revenue in several cases. Apparently the administration by the Bureau is still tied up with the older and less satisfactory idea of the meaning of accruals.

The accrual or accumulation basis is definitely recognized in amortization provisions, which have been a part of the income tax system since 1913. The favored method has been a straight line method, although the output basis or others are permitted if they are considered good accounting methods under the circumstances existing. Historical cost has been

the basis favored (except for depletion calculations) and has always been accepted.

Leaseholds and leasehold expenses may be amortized over the period of the lease; leasehold improvements are to be amortized over the shorter of the lease term or the asset life; drawings, models, designs, and other prepaid items may be spread over their useful life; premiums and discounts on bonds issued may be written down over the life of the bonds.

Depreciation was recognized in 1913. Decreases in market value do not increase depreciation, nor does appreciation offset depreciation. Repairs do not make depreciation entries unnecessary, but the expenditure for repairs may be deducted in addition to the amortization charge for depreciation.

There has been little change in fundamental provisions regarding depreciation, except that the administration of the law has been much more strict since 1934. A heavier burden of proof is now placed on the taxpayer; he may not take advantage of previous depreciation errors; future depreciation is to be computed over the estimated remaining life and may have to be adjusted yearly. In general, accounting methods are paralleled quite closely by the tax provisions.

Depletion provisions have strayed farther from good accounting and business procedure than have most other provisions in the law. In 1913, 1916, and 1917, depletion was required to be computed on cost, but the allowable deduction was arbitrarily restricted. In 1918, discovery value was introduced for mines and oil and gas wells. It was restricted to mines in 1926 and to certain types of mines only, in 1932. In 1926, percentage depletion was permitted for oil and gas wells and in 1932 was extended to the mines excluded from using discovery value depletion.

Both discovery value depletion and percentage depletion deviate widely from an acceptable method computation. They have been justified as a necessary subsidy to a particular type of industry and also because depletion estimates are necessarily inaccurate. It would be better to put depletion on a cost recovery basis. Depletion on cost has always been permitted for all wasting assets and is required in the case of timber.

Anything which decreases the use-life of an asset must be reflected in an increased amortization charge against gross income. Obsolescence falls within this general class. It was recognized specifically in 1918, and since has been deductible if it is reasonably predictable and measurable. Amortization of the obsolescence of intangibles such as patents, organization expenses, copyrights, trademarks, and goodwill is not permitted, because the amount is not capable of being measured accurately and objectively. Except for goodwill and trademarks, these intangibles are subject to depreciation, however.

The amortization of unamortized bond discount frequently has been disallowed by the Commissioner but has been upheld by the Board of Tax Appeals. Its status has been summed up in a Treasury Decision issued in 1935. It is deductible at the time bonds are retired, if they are retired for cash. The same rule applies even if the cash is derived from a new stock issue. If the bonds are amortized by an exchange for shares, no deduction may be taken until the shares are sold. If the refunding of bonds is accomplished by the issuance of new bonds, the unamortized discount on the old bonds is to be spread over the term of the new bonds.

From 1913 to 1918, only the write-off method was permitted for bad debts, but since the 1921 Act, the taxpayer may use the reserve method. Worthless securities were treated as bad debts from 1918 through 1936; in 1938 they were required to come under the capital loss provisions in order to harmonize the provisions regarding losses on exchanges and losses on abandonment.

In general, the income tax has upheld the idea of strict periodicity in its requirements that adjustments of errors be made through amended returns. It has permitted exceptions from periodicity when it was necessary in order to get a correct reflection of income or when unimportant overlapping items have been handled consistently.

The long-range view of income, rather than periodicity, has been recognized in carryover provisions for losses. A two-year carryover was permitted in all years from 1918 to 1928, except 1920. In 1932 the period was reduced to one year and was omitted entirely in 1933. It was reinstated for a very limited use in 1938 and was fully reinstated in 1939 to include a two-year period. Unfortunately, the loss to be carried over has always been restricted and has not been the same figure as shown on the tax return.

The Federal income tax places its emphasis on periodic income calculations but has overlooked strict periodicity on occasion.

Income Tax Concept of Income

The income tax concept of income is: the modified net increase in assets, recognized as it accumulates or at a given moment from most sources, measured in terms of money, generally between two points of time, excluding non-income adjustments to the store of capital.

Although there are some provisions and methods used in the income tax system which are objectionable, most of the tax system conforms with accounting practice. Accountants and businessmen are indebted to the income tax for the recognition it contains of accounting. It has caused the adoption in business of correct accounting procedures, in many cases. In other cases, it has deviated from accounting procedures and has caused a healthy reexamination of such accounting procedures.

Some of the criticism directed at the Federal income tax is not altogether fair, because too frequently perfection is demanded. Businessmen and accountants are as often guilty as is the tax system of inconsistency and the use of poor income determination methods; it is rather unfair to demand that tax provisions conform with generally accepted, satisfactory methods when such do not always exist. Many business and accounting procedures result in understatements of income in the interest of conservatism. Often it is difficult to justify such understatements, even for general business purposes. There seems to be no reason why such understatements should be permitted for tax purposes, because an income tax should be based on the most accurate income figure obtainable.

Most of the adverse criticisms are, and should be, restricted to other than the theoretical aspects of income determination.[4] Some of these other items to which objection has been raised are: unstable policies in the Treasury Department and the statutes, inconsistent rulings on parallel cases, expensive litigation, complicated statutory provisions, expense of gathering tax data, conflicting and overlapping requirements of the many governmental units, political expediency, surtaxes on undistributed and excess profits, inclusion in the tax law of penalties and subsidies for non-revenue purposes, rates, administrative methods, and similar non-income determination items.

NOTES

Abbreviations Used in Citations and Sources of Rulings

BUREAU OF INTERNAL REVENUE

Court Decision (Ct.D.).
Cumulative Bulletin (C.B.).
General Counsel Memorandum (G.C.M.).
Income Tax Unit Ruling (I.T.).
Mimeographed Letter (Mim.).
Office Decision (O.D.).
Opinion of Attorney General (Op.A.G.).
Press Release (P.R.)
Regulations (Reg.).
Solicitor's Law Opinion (O. or L.O.).
Solicitor's Memorandum (S.M.).
Solicitor's Opinion (Sol.Op.).
Solicitor's Recommendation (S.R.).
Treasury Decisions (T.D.).
Treasury Department Circular (D.C.).

ADVISORY

Advisory Tax Board Memorandum (T.B.M.).
Advisory Tax Board Recommendation (T.B.R.).
Committee on Appeals and Review Memorandum (A.R.M.).
Committee on Appeals and Review Recommendation (A.R.R.).

BOARD OF TAX APPEALS (B.T.A.)

COURTS

United States Circuit Court of Appeals (C.C.A.).
United States Supreme Court (S.Ct.).

NOTES—CHAPTER I

1—Haig, "The Concept of Income—Economic and Legal Aspects," *The Federal Income Tax* (1921), p. 18. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, p. 335. Greer, "What Are Accepted Principles of Accounting?" *Accounting Review*, March, 1938, p. 25. Greer, "Application of Accounting Rules and Standards to Financial Statements," *Accounting Review*, December, 1938, p. 340. Sanders-Hatfield-Moore, *A Statement of Accounting Principles*, 1938, p. 5.

2—For a more complete discussion of the function of accounting, see Chapter II of this study.

3—Green, *Lectures on Taxation* (1932), p. 81.

4—For a good discussion of this matter, see Harding, *Double Taxation of Property and Income* (1933).

5—Baily, *Relative Merit of Partnership and Corporate Organization Under the Income Tax Law,* Thesis, 1921, p. 23. "As a result of the method of levying income taxes by the Revenue Act of 1918 the per cent of the profits of a given business that is taken by the various income taxes is affected by the form of the business organization."

NOTES—CHAPTER II

1—Haig, "The Concept of Income—Economic and Legal Aspects," *The Federal Income Tax* (1921) p. 2. See also Taussig, *Principles of Economics,* I (1916) p. 134; Fisher, I., *Elementary Principles of Economics* (1911) p. 34; Seligman, *Principles of Economics* (1914) p. 16; Ely, *Outlines of Economics* (1908) p. 98.

2—Fisher, *The Nature of Capital and Income* (1902) p. 52.

3—Editorial, *Journal of Accountancy,* February, 1938, p. 89. In December of 1937, in a round table discussion by the American Economic Association at Atlantic City, leaders of the discussion favored defining income as "the accretion to economic power between two points of time."

4—Haig, *op. cit.,* p. 7.

5—*Ibid.,* p. 11. ". . . the economist when asked whether a particular item is income or is not income, must, in the opinion of this writer, make his reply depend upon whether the receipt of that item has increased the economic power of the recipient to command satisfaction-yielding goods or services. If it does, it is income; if it does not, it is not income."

6—Taussig, *op. cit.,* p. 4. ". . . for almost all purposes of economic study, it is best to content ourselves with a statement, and an attempt at measurement, in terms not of utility but of money income. . . . The reason for this rejection of a principle which is in itself sound lies in the conclusion . . . regarding total utility and consumer's surplus: They cannot be measured."

7—Plehn, *Public Finance,* 5th ed. (1926) p. 225. "Receipts during a given time in money or money's worth."

8—Pulgrave, *Dictionary of Political Economy,* II, p. 374. ". . . the wealth, measured in money, which is at the disposal of an individual, or a community, per year, or other unit of time."

9—Fetter, 'Reformulation of the Concepts of Capital and Income in Economics and Accounting," *Accounting Review,* XII, p. 10. ". . . any sort of goods (or valuable rights) coming into the possession of a person, available for consumers use without depletion of a formerly existing physical stock, or a financial capital fund, as the case may be."

10—Marshall, *Principles of Economics,* 8th ed., p. 74. "When a man is engaged in business, his profits for the year are the excess of his receipts from his business during the year over his outlay for his business; the difference between the value of his stock and plant at the end and at the beginning of the year being taken as part of his receipts or as part of his outlay, according as there has been an increase or a decrease in value."

11—For a detailed discussion of "realization," see Chapter IV. Other elements in the income concept are treated more fully in Chapters III through X.

12—Hatfield, *Accounting* (1927) p. 241. "The author has vainly tried to find any accepted differentiation between these two items."

13—*Ibid.*

14—Finney, *Principles of Accounting*, I (1929) Ch. 2, 1. "The profits of a business venture can be determined with absolute accuracy only when the business is terminated, the assets realized, the liabilities liquidated, and the residue distributed among the owners. Then any excess of the amount distributed to the owners over the amount invested, plus any distributions to owners during the life of the business, would constitute profits."

15—Paton, *Accounting Theory* (1922) p. 254.

16—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932), p. 41. "If absolutely accurate balance-sheets could be prepared at the beginning and at the end of a period, the difference between their surplus accounts (withdrawals, dividends, and allowances being considered) would represent the net income or deficit for the term; but the valuation and revaluation of capital assets involves too much speculation to permit the recognition of such a practice as satisfactory. This, in effect, is the method used to obtain results in single entry, but its utter failure to justify itself is reason enough for abandoning it."

17—Hosmer, "The Effect of Direct Charges to Surplus on the Measurement of Income," *Accounting Review*, March, 1938, p. 47. ". . . net income in accounting means the change in proprietorship in any period from all causes other than new investment . . . , and includes non-operating charges and extraordinary items regardless of size and regardless of the period to which they refer. Irregular income figures would result, it is true, if such items as plant writedowns and security losses were carried through income; but over a term of years there would be a more complete picture of income, and the statements of different corporations would be more nearly comparable."

18—Montgomery, *Auditing—Theory and Practice*, I, p. 309.

19—Haig, *op. cit.*, p. 14.

20—Dickinson, *Accounting Practice and Procedure*, p. 67.

21—Kester, *Advanced Accounting*, 3rd ed., p. 492.

22—Newlove-Smith-White, *Intermediate Accounting* (1939) p. 60.

23—*Ibid.*

24—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) p. 41. See Wildman, *Principles of Accounting*, p. 184, for a similar expression.

25—Hatfield, *Accounting* (1927) p. 242.

26—*Ibid.*, p. 248.

27—Staub and Bell, "The Disposition in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants*, January, 1933, p. 17. "That term has been defined by the Special Committee on Terminology of the American Institute of Accountants as 'The balance remaining after deducting from the gross income all costs, charges, expenses, and losses which have accrued during a given period, together with the amount of reserves which may have been set up.' 'Gross Income' is defined by the same committee as including 'sales, rentals, interest, profits from the sale of capital assets and ascertained excess of reserves.' According to this definition, net income should embrace all profits and be charged with all losses of whatever nature, including profits and losses from sale of capital assets. This may perhaps be regarded as an ideal conception of the matter at least as far as results of operations, as distinguished from capital gains and losses, are concerned, but at all events actual practice indicates that the principle is not generally recognized, as to either credits or charges. On the contrary, the consensus of opinion seems to be that net income means the balance of earnings or profits from operations which can be regarded as indicating the normal earning power of the business for the particular period."

28—The discussion of the income tax concept of income at this point is concerned only with what courts and writers have specifically said income is. The concept revealed by statutory provisions and their interpretation is deferred to later chapters.

29—It has been held frequently that this amendment has not extended the tax power to new subjects of taxation, but has merely removed the necessity for apportionment of taxes on income.

Brushaber v. Union Pacific R. R. Co., 240 U.S. 1, 17-19; 36 Sup. Ct. 236 (1916). Stanton v. Baltic Mining Company, 240 U.S. 103, 112 *et seq.*; 36 Sup. Ct. 278 (1916). Peck & Co. v. Lowe, 247 U.S. 165, 172, 173; 38 Sup. Ct. 432 (1918).

30—"In determining the definition of the word 'income' the Court has consistently refused to enter into the refinements of lexicographers or economists and has approved what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."

Merchants Loan & Trust Co. v. Smietanka, 255 U.S. 509, 41 Sup. Ct. 386 (1921). Willcuts v. Bunn, 282 U.S. 216, 51 Sup. Ct. 125 (1931). Eisner v. Macomber, 252 U.S. 189 (1920). Gavit v. Irwin, Col., 275 Fed. 643 (1921). For a further discussion of this point see Chapter I of this study.

31—Littleton, "What is Profit?" *Accounting Review*, September, 1928, p. 278.

32—231 U.S. 399, 415; 34 S.Ct. 136 (1913).

33—247 U.S. 179; 38 S.Ct. 467 (1918).

34—1 Fed. 689 (1923).

35—See Corpus Juris.

36—St. Johns v. Erie Railway Co., 21 Fed. 167 (1874).
Russel v. Bristol, 49 Conn. 251.

37—Gavit v. Irwin, 275 Fed. 643 (1921).

38—252 U.S. 189 (1920).

39—Also see Ludington v. McCaughn, 1 Fed. 689 (1923) on page 13 of this chapter.

40—Chapter I of this thesis.

41—Dohr, "The Board of Tax Appeals and Net Income," *Journal of Accountancy*, June, 1926, p. 429.

42—Montgomery, "Dealings in Treasury Stock," *Journal of Accountancy*, June, 1938, p. 473.

43—Seligman, "Are Stock Dividends Income?" *American Economic Review*, September, 1919, p. 528.

44—*Ibid.*

45—American Institute of Accountants Committee on Federal Taxation, "Proposed Changes in Federal Revenue Law," *Journal of Accountancy*, November, 1937, pp. 349 and 351.

46—Blough, "The Relationship of the Securities and Exchange Commission to the Accountant," *Journal of Accountancy*, January, 1937, p. 25. Editorial, "A Forward Step in Tax Administration," *Journal of Accountancy*, December, 1938, p. 355. Halsey, Laurence, "The Position of the Public Accountant in Relation to Business and the Government in Great Britain," *Journal of Accountancy*, September, 1938, p. 178.

47—May, G. O., "The Influence of Accounting on the Development of an Economy," (Pamphlet), 1936, p. 4. Editorial, "The Need for Tax Reform," *Journal of Accountancy*, January, 1937, p. 1.

48—Provisions similar to Article 323, Regulations 74, are found in: Article 323, Regulations 77, 1932. Article 41-3, Regulations 86, 1934. Article 41-3, Regulations 94, 1936. Article 41-3, Regulations 101, 1938.

49—Blough, "Accountant's Certificates," *Journal of Accountancy*, February, 1938, pp. 106, 110.

50—Greer, "What Are Accepted Principles of Accounting?" *Accounting Review*, March, 1938, p. 25, quoting Blough.

51—Greer, "Application of Accounting Rules and Standards to Financial Statements," *Accounting Review*, December, 1938, p. 340.

52—Smith, "*Some Variations from Accounting Principles in Federal Income Tax Law*" (Thesis) 1928. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, pp. 333, 335. Byerly, "Formulation of Accounting Principles or Conventions," *Journal of Accountancy*, August, 1937, p. 94. Byrne, G., "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards," *Journal of Accountancy*, November, 1937, p. 365. Harvey, "Some Observations on Accounting Practice with Special Reference to Inventory Valuation," *Journal of Accountancy*, December, 1937, p. 440. Greer, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" *Journal of Accountancy*, March, 1938, pp. 213, 223. Greer, "What Are the Accepted Principles of Accounting?" *Accounting Review*, March, 1938, p. 25. Paton, "Comments on 'A Statement of Accounting Principles,'" *Journal of Accountancy*, March, 1938, p. 196. Shallenberger, "An Accountant's Responsibility to Client, Profession, and Public," *Journal of Accountancy*, October, 1939, p. 261.

53—Greer, "What Are the Accepted Principles of Accounting," *Accounting Review*, March, 1938, p. 27. One hundred and fifty annual financial statements were studied; all were certified by C.P.A.'s; all companies were engaged in similar lines of business; all faced similar accounting problems. "The examination of these statements discloses a considerable lack of uniformity in the treatment of items and transactions of identical character. These variations have been sufficient to convert losses into profits, to alter materially the values assigned to important assets, and to render the several statements wholly noncomparable except with substantial revisions in the interests of consistency." *Ibid.*, p. 29: ". . . for this group of companies, over the eight-year period reviewed, the most restrictive application of these principles with relation to profits would have produced an aggregate net profit for all the companies combined of about 125 million dollars, while the most liberal application, if consistently followed, would have produced an aggregate profit of about 275 million dollars. It is noteworthy also that none of the differences result from the difficulties of measurement of values (in which accounting judgment is considered so important); they arise exclusively from differing opinions as to what constitutes profit."

54—Paton, "Valuation of Inventories," *Journal of Accountancy*, December, 1922, p. 449. Ballantine, "Taxable Income," *Journal of Accountancy*, November, 1925, p. 349. American Institute of Accountants, *Examination of Financial Statements by Independent Public Accountants* (Pamphlet) January, 1936, p. 4. May, "The Influence of Accounting on the Development of an Economy," *Journal of Accountancy*, January, 1936, p. 13. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, pp. 335, 349, 350. Byrne, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" *Journal of Accountancy*, November, 1937, p. 369. Byerly, "Formulation of Accounting Principles or Conventions," *Journal of Accountancy*, August, 1937, p. 98. Montgomery, "What Have We Done, and How?" *Journal of Accountancy*, November, 1937, p. 345. Greer, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" *Journal of Accountancy*, March, 1938, pp. 213, 215. Collins, "Report of the President," *Journal of Accountancy*, November, 1938, p. 293. Staub, "Uniformity in Accounting," *Papers on Accounting Principles and Procedure, 1938*, p. 4. Scott,

"Accounting Principles and Cost Accounting," *Journal of Accountancy*, February, 1939, p. 70. American Institute of Accountants Committee on Federal Taxation, "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, p. 307.

55—See other portions of this chapter for a justification of this statement and the limitations which surround it.

56—Scott, "The Tentative Statement of Principles," *Accounting Review*, September, 1937, pp. 296, 301.

57—Littleton, "The Relation of Function to Principles," *Accounting Review*, September, 1938, p. 234. "A single coordinated body of theory must have one unifying core, one central purpose, one primary function." Kaplan and Reaugh, "Accounting, Reports to Stockholders, and the SEC," *Accounting Review*, September, 1939, p. 229.

58—*Ibid.*

59—Paton and Littleton, *An Introduction to Corporate Accounting Standards* (1940), 1.

60—Hatfield, *Accounting* (1927) pp. 25, 66. Martin, "Surplus Arising Through Revaluation," *Accounting Review*, June, 1927, p. 111. May, *The influence of Accounting on the Development of an Economy* (Pamphlet) 1936, pp. 11, 12. Littleton, "Value and Price in Accounting," *Accounting Review*, September, 1929, p. 149. Littleton, "The Relation of Function to Principles," *Accounting Review*, September, 1938, p. 237. Husband, "Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles," *Accounting Review*, December, 1937, p. 386. Taylor, "Valuation of Fixed Assets and Principles Related to Write-ups and Write-ins," *Papers on Accounting Principles and Procedure, 1938*, p. 17. Chamberlain, H. T., "Adjustments of Fixed Assets," *Papers on Accounting Principles and Procedure, 1938*, p. 11. Littleton, "The Uses of Theory," *Journal of Accountancy*, April, 1939, p. 231. Kaplan and Reaugh, "Accounting, Reports to Stockholders, and the SEC," *Accounting Review*, September, 1939, p. 205. American Accounting Association, *Revised Outline of Principles* (Unpublished manuscript), 1.

61—Kester, *Accounting—Theory and Practice*, II (1920) p. 86. Editorial, *Journal of Accountancy*, July, 1921, p. 46. Hatfield, *Accounting* (1927), pp. 66, 76. May, *The Influence of Accounting on the Development of an Economy* (1936), pamphlet, p. 6. Husband, "Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles," *Accounting Review*, December, 1937, pp. 386-7. Healy, R., "The Next Step in Accounting," *Accounting Review*, March, 1938, p. 6. Sanders-Hatfield-Moore, *A Statement of Accounting Principles*, 1938, esp. p. 113. Newlove-Smith-White, *Intermediate Accounting* (1939), pp. 116, 118, 125, 126, 200, 201, 244. Kaplan and Reaugh, "Accounting, Reports to Stockholders, and the SEC," *Accounting Review*, September, 1939, p. 227.

62—Rorem, "Replacement Cost in Accounting Valuation," *Accounting Review*, September, 1929, p. 167. Scott, "Accounting Principles and Cost Accounting, *Journal of Accountancy*, February, 1939, p. 74. Scott, "The Tentative Statement of Principles," *Accounting Review*, September, 1937, p. 298.

63—Castenholz, "The Accountant and Changing Monetary Values," *Accounting Review*, December, 1931, p. 282.

64—Paton, "Comments on 'A Statement of Accounting Principles,'" *Journal of Accountancy*, March, 1938, p. 201. But see, Newlove-Smith-White, *Intermediate Accounting* (1929) pp. 116, 122, for a defense of "sensible" conservatism.

NOTES—CHAPTER III

1—The exclusion of additional investments and withdrawals is to be assumed in any further discussion of this broad concept of income.

2—See Chapter VI for a discussion of the nature of the corporation.

3—See Chapter VI.

4—By matching is not meant equality. What is meant is that two items are paired if relationship can be discerned.

5—In as much as some commodities have a short life and furnish only a single use, deferments are not always necessary.

6—American Accounting Association, unpublished draft manuscript (1938) p. 24.

7—"Accrual" method really means "matching" method; both accruals and deferments are used in the so-called "accrual" method.

8—Kester, *Accounting Theory and Practice,* II (1920 p. 86. Finney, *Principles of Accounting,* I (1929) Ch. 2, p. 3. Staub, *Journal of Accountancy,* October, 1929. American Accounting Association, "A Tentative Statement of Accounting Principles," *Accounting Review,* June, 1936. Byrne, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" *Journal of Accountancy,* November, 1937, p. 364. Littleton, "Tests for Principles," *Accounting Review,* March, 1938, p. 19. "Periodic costs and their related revenues are the most important data for accounts to produce." Montgomery, *Auditing Theory and Practice,* I, p. 309. Also see footnote 18, Chapter II.

9—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) p. 44.

10—Brilliant Coal Company v. U.S., 59 Ct. Cl. (1924); 4 American Federal Tax Reports 3845. "There can be no doubt that under this act (1913) there could be no interest deduction unless it both accrued and was paid during the year. It cannot be conceived that Congress meant anything else or that it did not use both words advisedly."

In this case, the corporation was unable to pay interest on its bonded debt in the years of 1913 to 1916, inclusive. In 1917 it paid all of the past due interest plus that for 1917, and the total amount was permitted to be deducted.

To similar effect: Routzahn, Collector v. F. H. Mason, Circuit Court of Appeals, *Journal of Accountancy,* September, 1926, p. 210.

11—Article 126, Regulations 33, 1916, 1917.

12—*Ibid.*

13—Article 127, Regulations 33, 1916, 1917.

14—"Paid or Accrued" must be construed in the alternative; both bases must not be combined in one tax return. Henry Reubel, 1 (1924-25) BTA 676. Chas. J. Kelley, 8 (1927) BTA 296. And others.

15—1921, Sec. 200(4). 1938, Sec. 43, Sec. 48(c); Reg. 101, Art. 43-1.

16—For similar provisions, see: 1924, Reg. 65, Art. 1523. 1938, Reg. 101, Art. 43-1.

17—Ways and Means Committee, 68th Congress, 1st Session, House Report 179, pp. 10-11.

18—1913, Reg. 33, Art. 123. 1938, Reg. 101, Art. 23(a)-3.

19—American Institute of Accountants Committee on Federal Taxation, "Proposed Changes in Federal Revenue Law," *Journal of Accountancy,* November, 1937, p. 349.

20—1918, Reg. 45 (1920 ed.) Art. 111.

21—For carry-over provisions for net losses, see the latter part of this chapter.

22—1921, Reg. 62 (1922 ed.) Art. 111. 1938, Reg. 101, Art. 43-2.

23—Bank of Hartsville, 1 (1924-25) BTA 920. Bass. Pub. Company, 12 (1928) BTA 728. Barstow & Company v. Bowers, 15 F 2d. 75. Kansas City Southern Railway Co. et al., 75 F. 2d. 786, reversing 22 (1931) BTA 949. And others.

24—American Institute of Accountants, *Examination of Financial Statements* (1936) p. 3.

25—1916, Reg. 33, Art. 128. 1917, Regg. 33, Art. 128.

26—Treasury Ruling 106 re: Sec. 326, Art. 839, Reg. 45, 1918. Union Metal Mfg. Co., 1 (1924-25) BTA 395. American Arch Company, 33 (1935-36) BTA 705. Woolford Realty Co. Inc., v. Rose, 286 U.S. 319, 1932. And others.

27—First National Bank of Sonora, Texas, 6 (1927) BTA 555. Northern National Bank, 16 (1929) BTA 608.

28—Sunburst Oil Refining Co., 23 (1931) BTA 829. Baltimore & Ohio Railroad Co., 30 (1934) BTA 194.

29—Bell, "The Disposition in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants,* January, 1933, p. 19. Newlove-Smith-White, *op cit.*, p. 357. But see: Sanders-Hatfield-Moore, *op. cit.*, pp. 40, 41, 114.

30—American Accounting Association, *Revised Outline of Principles* (Unpublished manuscript) p. 9. *Idem. A Tentative Statement of Accounting Principles* (Pamphlet) 1936, pp. 10, 11.

31—*Ibid.*, p. 10. *Idem. Revised Outline of Principles,* p. 9, 10.

32—Green, P., *The Income Statement* (thesis) 1927, p. 52. Fear is expressed that amended statements required for income tax purposes will lead to incorrect accounting and that corrections of the errors of previous years will be buried in the current profit and loss figure in order to avoid the preparation of amended returns for income tax use.

33—1916-17, Reg. 33, Art. 126. U.S. v. Woodword, 256 U.S. 632, 1921. Lucas v. American Code Co., Inc., 280 U.S. 445, 50 S.Ct. 202, 1930.

34—I.T. 1272, C.B., June, 1922, p. 123.

35—L.O. 1086, C.B., June, 1922, p. 87.

36—Yale and Towne Manufacturing Company, 269 U.S. 422 (1926).

37—Reference here is to T.D. 2433.

38—U.S. v. Anderson, et al., 46 S.Ct. 131, 269 U.S. 422 (1926); T.D. 3839, C.B., June, 1926, p. 179. D'Olier, et al., v. U.S., Ct. Claims (1926).

39—L. S. Ayers & Co., 1 (1924-25) BTA 1135. Guarantee Construction Company, 2 (1925) BTA 1145.

40—39 F. 2d. 940.

41—David Baird and Son, Inc., 2 (1925) BTA 901. See also: Spiegel, May, Stern Co. v. U.S., 69 Ct. Cl. 110, 37 F. 2d. 988.

42—Falketind Ship Company, 6 (1927) BTA 44. To the same effect: I.T. 2080, C.B., Dec., 1924, p. 48.

43—Letter from J. R. Kirk, Deputy Commissioner (May 3, 1939).

44—Western Wheeled Scraper Company, 14 (1928-29) BTA 496.

45—Automobile Underwriters, Inc., 19 (1930) BTA 1160, Nonacq., C.B., June, 1931, p. 73.

46—New Orleans Cold Storage and Warehouse Co., Ltd., 40 (1939) BTA 27.

47—Godfrey L. Cabot, Inc., v. Commissioner, 40 (1939) BTA 64.

48—Editorial, "The 'Accrual' Basis of Accounting," *Journal of Accountancy,* January, 1940, p. 8.

49—Lucas v. American Code Company, 280 U.S. 445. Also see Chapter VIII of this study.

50—In the following cases, the fact that items were improperly termed reserves on the taxpayers' books did not prevent the Board of Tax Appeals from recognizing their deductibility if they were properly accrued: Kleeman Dry Goods Company, 2 (1925) BTA 369. Rogers, Brown & Crocker Bros., Inc., 32 (1935) BTA 207. Anderson-Clayton Securities Corp., 35 (1936-37) BTA 795.

51—See discussion in Chapter V.

52—American Accounting Association, *Revised Outline of Principles* (Unpublished manuscript) p. 8.

53—O.D. 516 C.B., June, 1920, p. 112. Wm. J. Osthemer, 1 (1924-25) BTA 18. The Belt Ry. Co. of Chicago, 9 (1927-28) BTA 304, affd. 36 F. 2d 541. Harris-Emery Company, 10 (1928) BTA 297.

54—Finney, *Principles of Accounting*, I (1929) Ch. 28, p. 6.

55—Kester, *Accounting Theory and Practice*, II (1920) p. 416.

56—Newlove-Smith-White, *op. cit.*, p. 448. *Accounting Questions and Answers* (February, 1934) pp. 72, 73.

57—Nissley, "Charges Against Surplus," *Papers on Accounting Principles and Procedure* (1938) p. 38.

58—1913, Reg. 33, Art. 122.

59—1916-17, Reg. 33, Art. 144.

60—Pan American Hide Co., 1 (1924-25) BTA 1249. Potts Run Coal Company, 19 (1930) BTA 1. Spring Canyon Coal Co. v. Commissioner, 43 F. 2d 78, aff. 13 (1930) BTA 189. And others.

61—Paton and Stevenson, *Principles of Accounting*, p. 532 (quoted by Walker, "Non-Purchased Goodwill," *Accounting Review*, Sept. 1938, p. 255.) American Accounting Association, *Revised Outline of Principles* (Unpublished manuscript, 1938), p. 8.

62—I.T. 1272, C.B., June, 1922, 123. W. J. Ostheimer, 1 (1924-25) BTA 18. Helvering v. Russian Finance & Construction Corp., 77 F. 2d 324.

63—1913, Reg. 33, Art. 126.

64—*Ibid.* T.D. 2433, January 8, 1917. Helvering v. Russian Finance & Construction Corp., 77 F. 2d 324. But see: Commr. v. Old Dominion S.S. Co., 47 F. 2d 148, affing. 16 BTA 264.

65—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) p. 65.

66—T.B.R. 13, C.B., 1919, 103. O.D. 146, C.B., 1919, 221. I.T. 1272, C.B., June, 1922, 123. W. J. Ostheimer, 1 (1924-25) BTA 18. I.T. 2342, C.B., June, 1927, 178 (Revoked I.T. 1348, C.B., June, 1922, 51). G.C.M., 1342, C.B., June, 1927, 177. (In effect overruled I.T. 1710, C.B., December, 1923, 45.) Farmville Oil Fertilizer Co., 30 (1934) BTA 1048, affd. 78 F. 2d 83. Shapleigh Hardware Company v. U.S., 81 F. 2d 697. And others. See Chapter V of this thesis.

67—Farmville Oil Fertilizer Co., 30 (1934) BTA 1048; affd. by 78 F. 2d 83; Ct. D. 1034, C.B., Dec., 1935, 184.

68—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) p. 41.

69—The following are only a few of many such decisions: W. J. Ostheimer, 1 (1924-25) BTA 18. Yost Auto. Co., 26 (1932) BTA 685. T.B.R. 13, C.B., 1919, 103. Readers Pub. Corp. v. U.S., 69 Ct. Cl. 681. Ewing Thomas Const. Co. v. McCaughn, 30 F. 2d 166, affing. 1 BTA 121. Lane Constr. Corp. v. Commissioner, 49 F. 2d 1080, affing. 17 BTA 826. 1913, Reg. 33, Art. 126.

70—See Chapter V of this thesis.

71—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) p. 64.

72—*Ibid.*, p. 42.

73—Walde Company, 1 (1924-25) BTA 332. Thomas Cronin Co. v. Lewellyn, T.D. 3795, C.B., June, 1926, 203; 9 F. 2d 974. Quality Roofing Co., 16 (1929) BTA 1371. Harrison, et al. Receivers of Thomas Cronin Co. v. Heiner, 28 F. 2d 985, 990. Vaug and Lanz, et al. Receivers of Thomas Cronin Co. v. Lewellyn, Ct. d. 134, C.B., Dec. 1929, 283; 35 F. 2d 283. And others.

74—Memorial Park Development Co., Memo. BTA, Feb. 23, 1939.

75—Mason Securities Association v. Helvering, U.S. Cir. Ct. of App., 8th Cir., March 14, 1939. Affing. 36 (1937) BTA 958.

76—Acacia Park Cemetery Association v. Commr., 67 F. 2d 700, 703.

77—1926, Sec. 214 (a) (11); Reg. 69, Art. 261. 1928, Sec. 23(o). 1932, Sec. 23(o).

78—O.D. 226, 1 C.B. 76, 1919. O.D. 567, 3 C.B., 108. Kentucky Land, Gas & Oil Co., 2 (1925) BTA 838. Cambria Development Co., 34 (1936) BTA 1155, nonacq., C.B. 1937-1, 31 (1918) Act. And others.

79—*Ibid.* (Cambria).

80—Mesta Machine Co., 12 (1928) BTA 523. Geo. Hyatt, 36 (1937) BTA 121. Pioneer Automobile Service Co., 36 (1937) BTA 213.

81—G.C.M. 20021, 1 R.B., 1938-21, 6; Dohr, "Income Divorced from Reality," *Journal of Accountancy*, December, 1938, 361.

82—Kester, *Accounting Theory and Practice*, II (1920) 396.

83—Scott, "Accounting Principles and Cost Accounting," *Journal of Accountancy*, February, 1939, 70.

84—American Institute of Accountants, *Accounting Questions and Answers* (1934) 72.

85—Finney, *Principles of Accounting*, I (1929) Ch. 2, p. 9.

86—Newlove-Smith-White, *op. cit.* (1939) p. 391.

87—*Ibid.*, p. 388.

88—*Ibid.*, p. 390.

89—*Ibid.*

90—*Ibid.*, p. 389.

91—*Ibid.*, p. 246.

92—See Chapter V.

93—S. J. Groves & Sons Co. v. U.S., U.S. Dist. Ct., Minn., July 17, 1939.

94—Safe Guard Check Writer Corp., 10 (1928) BTA 1262. Columbus Plate & Window Glass Co. v. Miller, 38 F. 2d 509.

95—Producers Fuel Co., 1 (1924-25) BTA 202. Raleigh S. F., 6 (1927) BTA 381. Fraser Brick Co., 10 (1928) BTA 1252.

96—Readers Publ. Co., v. U.S., 40 F. 2d 145, 69 Ct. Cl. 681.

97—McCauley-Ward Motor Supply Co., 10 (1928) BTA 394.

98—W. S. Buck Mercantile Co., 6 (1927) BTA 285.

99—Reuben H. Donnelly Corp., 22 (1931) BTA 175.

100—U.S. v. Kansas Pacific Railway Co., 99 U.S. 459 (1898).

101—Trorlicht-Duncker Co., 22 (1931) BTA 466. Stein-Bloch Co., 23 (1931) BTA 1161. Farmville Oil Fertilizer Co., 30 (1934) BTA 1048, affd. 78 F. 2d 83. And others.

102—*Ibid.* (Farmville). Celluloid Co., 9 (1927-28) BTA 989. S.M. 1931, C.B., June, 1924, 140. And other cases.

103—O. J. Morrison Department Store Co. v. Commissioner, 23 (1931) BTA 895.

104—Houghton & Dutton Co., 26 (1932) BTA 52.

105—O. J. Morrison Dept. Stores of Fairmont. v. U.S., U.S. Dist. Ct., West Virginia, December 20, 1937.

106—1932, Reg. 77, Art. 335. 1938, Reg. 101, Art. 42-5.

107—These plans are basically similar in nature.

108—American Institute of Accountants, *Examination of Financial Statements* (1936) p. 4.

109—One such plan requires three sections in the profit and loss statement: (1) recurring, operating items, (2) recurring, non-operating items, and (3) non-recurring, non-operating items. Corrections of errors in computation for prior periods would be placed in the third section, or perhaps, into an additional section.

110—Chapter V—NON-RECURRING ITEMS, carries a more complete discussion.

111—May, "Taxable Income and Accounting Bases for Determining It," *Journal of Accountancy*, October, 1925, p. 248.

112—For an extended discussion of "averaging" see, Atlas, "Average Income and Its Use in Taxation," *Accounting Review*, June, 1938, p. 124.

113—National Industrial Conference Board, *State and Local Taxation of Business Corporations* (1931).

114—For a more complete discussion, see: *Ibid.* Atlas, *op. cit.* *Report of the Wisconsin Tax Commission*, April 1, 1930, 196-8.

115—Atlas, *op. cit.*, 130.

116—National Industrial Conference Board, *State and Local Taxation of Business Corporations* (1931).

117—Pangborn, "The Federal Corporation Tax Law—The Injustice of the Law," *Journal of Accountancy*, September, 1909, p. 351.

118—Magill-Parker-King, *Summary of the British Tax System* (1934) p. 22.

119—Editorial, "A Disproprotionate Tax Law," *Journal of Accountancy*, July, 1937, p. 1.

120—American Institute of Accountants Committee on Federal Taxation, "Proposed Changes in Federal Revenue Law," *Journal of Accountancy*, November, 1937, p. 349; "Recommendations for Amendment of the Federal Revenue Act," *Journal of Accountancy*, May, 1938, p. 379.

121—Senate Finance Committee, 65th Congress, 3rd Session, Senate Report 617, p. 7.

122—*Ibid.*

123—Conference Committee, 65th Congress, 3rd Session, House Report 1037, p. 45. Senate Discussion, Congressional Record, Vol. 57, 513-18, 548.

124—In re: Brezin & Schaefer, Bankrupts, 297 Fed. 300 (1924).

125—1924, Sec. 206(b). 1926, Sec. 206(b). 1928, Sec. 117(b).

126—1932, Sec. 117(b).

127—1932, Sec. 117(d).

128—Senate Finance Committee, 72nd Congress, 1st Session, Senate Report 665.

129—Ways and Means Committee, 72nd Congress, 1st Session, House Report 708, 23.

130—N.I.R.A., 1933, Section 218(a).

131—House Discussion, 73d Congress, 1st Session, Congressional Record, Vol. 77.

132—American Institute of Accountants Committee on Federal Taxation, "Proposed Changes in the Federal Revenue Law" (Pamphlet) September, 1938. Editorial, "The Need for Tax Reform," *Journal of Accountancy*, January, 1937, pp. 1, 3.

133—Tarleau, "Revenue Revision," *Papers on Auditing Procedure* (1939), p. 259.

134—1939, Sec. 122(b).

135—1939, Sec. 122(e).

136—Tax years beginning on or after January 1, 1940 are the first in which such carried-forward losses may be deducted.

137—Cooper, "Business Appeasement as Reflected in the 1939 Revenue Act," *Journal of Accountancy*, August, 1939, p. 80.

138—Section 234 (a) (6) refers to dividends received from an income taxed corporation.

139—Title III dealt with the War and Excess Profits Tax.

140—Section 214 and Section 234 dealt with deductions allowed.

141—See Chapter V for a discussion of extraordinary gains and losses.

142—See Chapter IX for a discussion of discovery value depletion.

143—1924, Sec. 206(a). 1932, Sec. 117(a).

144—See Chapter IX for a discussion of percentage depletion.

145—1939, Sec. 122(a).

146—1939, Sec. 122(c).

147—1939, Sec. 122(d).

148—See Chapter V for a discussion of capital gains and losses.

149—Senate Finance Committee, 68th Congress, 1st Session, Senate Reports 398, 20.

150—See the provision of North Dakota Law, elsewhere in this chapter.

151—Unchanged in 1932, Section 117(a)(6), and appears also in 1939, in Section 122(d)(3).

152—Spotswood D. Bowers v. Commissioner, 80 F. 2d. 215.

153—Editorial, "Natural Business Year," *Journal of Accountancy*, December, 1939, p. 362.

154—1913, II, G(c). 1938, Sec. 41.

155—Swift and Company v. U.S., 69 Ct. Cl. 171.

156—1913, Reg. 33, Art. 165. 1917, Reg. 33, Art. 59.

157—Klanderman, "Changing from Calendar Year to Natural Business Year," *Journal of Accountancy*, December, 1939, p. 386.

158—See Chapter VIII.

159—See Chapter IX.

160—See Chapter V.

161—See Chapter IV.

162—Provision for relief by a partial mitigation of the effects of the statute of limitations has been provided in the 1938 Act (Section 820).

NOTES—CHAPTER IV

1—This chapter is concerned principally with the time for recognizing ordinary, recurring gross income items. Deductions are discussed in Chapters III, VIII, and IX. Inventory problems are taken up in Chapter X. Dividends, in Chapter VI. Chapter V contains a discussion of non-recurring items. The nature of gross income items is treated in Chapter VII.

2—Hatfield, *Accounting* (1927) p. 251. For individual expressions of this opinion see: Seligman, "Are Stock Dividends Income," *American Economic Review*, September, 1919, p. 517. Finney, *Principles of Accounting*, I (1929) Ch. 2, p. 2.

3—Hatfield, *Accounting* (1927) p. 251. Kester, *Accounting Theory and Practice*, II (1920) p. 297.

4—Husband, "Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles," *Accounting Review*, December, 1937, p. 396. Hatfield, *Accounting* (1927) p. 253.

5—Hatfield, *Accounting* (1927) p. 66. Littleton, "Value and Price in Accounting," *Accounting Review*, September, 1929, pp. 149, 150, 153. Littleton, "The Uses of Theory," *Journal of Accountancy*, April, 1939, p. 227. Littleton, "Suggestions for the Revision of the Tentative Statement of Accounting Principles," *Accounting Review*, March, 1939, pp. 57, 61.

6—See Chapter V for a more complete discussion.

7—Hatfield, *Accounting* (1927) p. 252. Martin, "Surplus Arising Through Revaluation," *Accounting Review*, June, 1927, p. 111. Wildman, "Appreciation from the Point of View of the C.P.A.," *Accounting Review*, December, 1928, p. 399. Littleton, "Value and Price in Accounting," *Accounting Review*, September, 1929, p. 148. Schmidt, "Is Appreciation Profit?" *Accounting Review*, December, 1931, p. 289. May, *The Influence of Accounting on the Development of an Economy* (1936) p. 11. Finney, *Journal of Accountancy*, Vol. 31, p. 389. Eisner v. Macomber, 252 U.S. 189 (1920). LaBelle Iron Works v. U.S., 256 U.S. 377 (1921).

8—Scott, "Valuation of Investment Securities," *Accounting Review*, December, 1928, p. 378. Daines, "The Changing Objectives of Accounting," *Accounting Review*, June, 1929, p. 94. Paton, "Comments on 'A Statement of Accounting Principles,'" *Journal of Accountancy*, March, 1938, p. 201.

9—1918, Reg. 45 (1920 ed.) Art. 52.

10—1921, Reg. 62 (1922 ed.) Art. 51. 1924, Reg. 65, Art. 50.

11—1926, Reg. 69, Art. 50. 1938, Reg. 101, Art. 42-1.

12—Maryland Casualty Co. v. U.S., 251 U.S. 342 (1920). U.S. v. Christine Oil & Gas Co., 269 Fed. 458 (1920).

13—1916, Sec. 13(d). Ways and Means Committee, 64th Congress, 1st Session, House Report 522, p. 4.

14—Clarence Schock, 1 (1924-25) BTA 528. Selwyn Eddy Co., 25 (1931-32) BTA 1341, Affd. 65 F. 2d 997.

15—Aluminum Casting Co. v. Rentzahn, 282 U.S. 92. Leon Iron Company, 14 (1928-29) BTA 830.

16—Chapter V.

17—See Chapter V for disallowances of some amortizations of losses and gains, and Chapter IX for allowable amortizations.

18—Hatfield, *Accounting* (1927) p. 257. Smith, W., *Some Variations from Accounting Principles in the Federal Income Tax Law* (1928), Thesis, p. 16.

19—Stempf, Letter to Roswell Magill, October 14, 1937, *Journal of Accountancy*, January, 1938, p. 10. Editorial, *Journal of Accountancy*, January, 1939, p. 2.

20—A.R.R. 737, C.B., June, 1922, p. 52.

21—See footnote 19.

22—Great Northern Railway, 8 (1927) BTA 225; Nonacq., C.B., December, 1928, p. 47. A. M. Campau Realty Co., 35 (1936-37) BTA 687. Corn Exchange Bank v. U.S., 37 F. 2d 34. Commissioner v. Brown, 54 F. 2d 563; Rev. 18 (1929-30) BTA 859. Commissioner v. Southeastern Ex. Co., 56 F. 2d 600; Rev. 19 (1930) BTA 490. And many others.

23—Grossett Lumber & Development Co., Inc., 29 (1933-34) BTA 705. See also: Brooklyn Union Gas Co., 22 (1931) BTA 507. Frederick S. Buggee, 32 (1935) BTA 580. Esther A. Saunders, Admnx. v. Commr., 17 F. Supp. 543 (1939).

24—1913, Reg. 33, Art. 134.

25—T.D. 2005, July 8, 1914.

26—1928, Reg. 74, Art. 332. 1938, Reg. 101, Art. 41-2.

27—Industrial Trust Co. v. Walsh, 222, U.S. 437. A. Sprunt & Son, Inc., 24 (1931) BTA 599.

28—May, "Introduction," *Papers on Accounting Principles and Procedure*—1938, 1. To similar effect: Green, Ed. H., "Some Aspects of the Problem of Income Taxation. . . ." *Lectures on Taxation* (1932) 75. Heilman, "Realized Income," *Accounting Review*, June, 1929, 81.

29—See Chapter III.

30—Dallas Transfer & Term. Whse. Co. v. Commr., 70 F. 2d 95.

31—H. S. Parker, 11 (1928) BTA 1336.

32—McNeill-Allman Construction Co. v. U.S., 21 F. Supp. 410. Cleveland Trinidad Paving Co., 20 (1930) BTA 772; affd. 62 F. 2d 85.

33—Benjamin Franklin Patterson, 21 (1930-31) BTA 8; rev. pet. dismissed.

34—Appeal of Consolidated Asphalt Co., 1 (1924-25) BTA 79. To similar effect: C. H. Mead Coal Co. v. Commr., 31 (1934-35) BTA 190. Grand Central Public Market v. U.S., 22 F. Suppl. 119.

35—Heilman, "Realized Income," *Accounting Review*, June, 1929, 80.

36—See pages 52-54.

37—See Chapter III.

38—See Chapter III.

39—O.D. 826, June, 1921, 95.

40—E. K. Wood Lumber Co., 25 (1931-32) BTA 1013.

41—Brown Lumber Co., 9 (1927-28) BTA 719; affd. 35 F. 2d 88.

42—McCreery, Purcell, Johnson and Edmonds, 4 (1926) BTA 967. A. H. Fell, 7 (1927) BTA 263. Schoellkopf Aniline & Chemical Works, Inc., v. U.S., 77 Ct. Cl. 529.

43—Hatfield, *Accounting* (1927) 255.

44—Heilman, *op. cit.*

45—Heilman, *op. cit.*

46—Ohio Brass Company, 17 (1929) BTA 1199.

47—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932) 55.

48—North American Oil Consolidated v. Burnet, 286 U.S. 417.

49—Santa Maria Gas Company, 10 (1928) BTA 1412. Bancitaly Corporation, 34 (1936) BTA 494. And others.

50—Byrne, "To What Extent Can the Practice of Accounting be Reduced to Rules and Standards?" *Journal of Accountancy*, November, 1937, 372.

51—1918, Reg. 45 (1920 ed.) Art. 44. 1938, Reg. 101, Art. 44-2.

52—S. A. Hinely, 2 (1925) BTA 1027. H. G. Stevens, 14 (1928-29) BTA 1120; Nonacq., C.B., June, 1929, S. L. Meyer, Ex., 23 (1931) BTA 1200.

53—1918, Reg. 45 (1920 ed.) Art. 46. 1938, Reg. 101, Art. 44-4.

54—Finney, *Principles of Accounting* I (1929) Ch. 11, p. 2.

55—1926, Sec. 212. 1938, Sec. 44(a).

56—1916-17, Reg. 33, Art. 116, 117, 120. 1938, Reg. 101, Art. 44-1.

57—1921, Sec. 202(f). 1938, Sec. 111(d).

58—1926, Sec. 212. 1926, Sec. 1208 (retroactive to 1916, 1917, 1918, 1921, and 1924). 1938, Sec. 44(b).

59—Ways and Means Committee, 70th Congress, 1st Session, House Report 2, 14-16.

60—Ways and Means Committee, 73d Congress, 2d Session, House Report, 704, 24.

61—1916-17, Reg. 33, Art. 116, 117, 120.

62—Pacheco Creek O. Co., 12 (1928) BTA 1358. E. G. Robertson, 19 (1930) BTA 534. C. J. Derbes, 24 (1931) BTA 276.

63—B. B. Todd, Inc., 1 (1924-25) BTA 762. H. B. Graves Co., Inc., 1 (1924-25) BTA 859. Hoover-Bond Co., 1 (1924-25) BTA 929. Charles A. Holman, 1 (1924-25) BTA 628. Six Hundred and Fifty West End Ave. Co., 2 (1925) BTA 958. A. R. Dennis, 2 (1925) BTA 977. Maurice E. Weed, 2 (1925) BTA 539. But see: Franc Furniture Co., 1 (1924-25) BTA 420.

64—1926, Reg. 69, Art. 42. 1938, Reg. 101, Art. 44-1.

65—O.D. 844, C.B., June, 1921, 123. A.R.R. 1216, C.B., December, 1922, 96. Franc Furniture Co., 1 (1924-25) BTA 420. Bradford Piano Co., 15 (1929) BTA 1045.

66—D. F. McCrimmon, 20 (1930) BTA 384. J. E. Sullivan, 23 (1931) BTA 147. E. N. Hazlett, 23 (1931) BTA 303. And others.

67—O.D. 792, C.B., June, 1921, 86. I.T. 2365, C.B., June, 1927, 69. Wilbur Voliva, 10 (1928) BTA 911. Voliva v. Commr., 36 F. 2d 212; Ct.D., C.B., June 1930, 301.

68—1916-1917, Reg. 33, Art. 121.

69—1916-1917, Reg. 33 ,Art. 121. 1938, Reg. 101, Art. 42-4.

70. Kester, *Accounting Theory and Practice,* II (1920) 400. Hatfield, *Accounting* (1927) 256. Finney, *Principles of Accounting,* I (1929) Ch. 28, p. 18. Littleton, "Suggestions for the Revision of the Tentative Statement of Accounting Principles," *Accounting Review,* March, 1939, 58.

71—T.D. 2161, February 19, 1915.

72—D. L. Wheelock, 10 (1928) BTA 540. R. G. Bent Co., 26 (1932) BTA 1369. And others.

73—Owen-Ames-Kimball Co., 5 (1927-27) BTA 921.

74—Cronin Co. v. Lewellyn, 9 F. 2d 974.

75—I.T. 1759, C.B., Dec., 1923, 31. No income is recognized until collection is made.

76—Webb Press Co., Ltd., 3 (1925-26) BTA 247, 9 (1927-28) BTA 238. Nancy Milling Co., 14 (1928-29) BTA 1001. Rice, Barton & Fales, Inc. v. Commr., 41 F. 2d 339; reversed 15 BTA 510.

77—Hatfield, *Accounting* (1927) 253, 254.

78—1928, Reg. 74, Art. 322. 1938, Reg. 101, Art. 41-2.

79—Paton, *Accounting Theory* (1922) 448. Kester, *Accounting Theory and Practice,* II (1920) 419.

80—Burnet v. Logan, Burnet v. Bruce, 283 U.S. 404, 51 S.Ct. 550, Ct.D. 351, C.B., June, 1931, 345. E. P. Cline, 15 (1929) BTA 934. J. Darsie Lloyd, 33 (1935-36) BTA 903; Nonacq., C.B., Dec. 1936, 39. G.C.M. 9798, C.B., December, 1931, 221. Commr. v. Garber, 50 F. 2d 588. Commr. v. Laird, 91 F. 2d 498. And others.

81—1928, Sec. 41; Reg. 74, Art. 321. 1938, Sec. 41; Reg. 101, Art. 41-1.

82—1938, Reg. 101, Art. 41-1.

83—*Ibid.,* Regulations, see footnote 81.

84—Seligman, "Are Stock Dividends Income?" *American Economic Review,* September, 1919, 517. Haig, *The Federal Income Tax* (1921) 4. Adams, "When is Income Realized?" *The Federal Income Tax* (1921).

85—Haig, *op. cit.*

NOTES—CHAPTER V

1—Both gross incomes and deductions are classified thus.

2—Kester, *Accounting Theory and Practice*, II (1920) 405. Dickinson, *Accounting Practice and Procedure* (quoted by Kester, *ibid.*). Haig, *The Federal Income Tax* (1921) 22, 25. Hunter, *Outlines of Public Finance* (1926) 300. Hatfield, *Accounting* (1927) 248, 280. Finney, *Principles of Accounting*, I (1929) Ch. 2, 2. Staub and Bell, "The Disposition in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants*, January, 1933, 7, 17. May, *The Influence of Accounting on the Development of an Economy* (1936) 15. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, 335. Stempf, "A Critique of the Tentative Statement of Accounting Principles," *Accounting Review*, March, 1938, 61. Hosmer, "The Effect of Direct Charges to Surplus on the Measurement of Income," *Accounting Review*, March, 1938, 45, 46, 47. Montgomery, "Dealings in Treasury Stock," *Journal of Accountancy*, June, 1938, 469. Littleton, "High Standards of Accounting," *Journal of Accountancy*, August, 1938, 101. *Ibid.*, "The Relation of Function to Principles," *Accounting Review*, September, 1938, 241. Paton, "Principles Related to 'Deferred Charges' and 'Prepaid Expenses,'" *Papers on Accounting Principles and Procedure—1938*, 28, 29. Nissley, "Charges Against Surplus," *Papers on Accounting Principles and Procedure—1938*, 39. Newlove-Smith-White, *Intermediate Accounting* (1939) 61, 411. Littleton, "Suggestions for the Revision of the Tentative Statement," *Accounting Review*, March, 1939, 63. Smith, "Capital Gains and Losses in Accounting," *Accounting Review*, June, 1939, 130, 131. Kaplan and Reaugh, "Accounting, Reports to Stockholders, and the SEC," *Accounting Review*, September, 1939, 221.

3—Hatfield, *Accounting* (1927) 242. Staub and Bell, "The Disposition in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants*, January, 1933. 17. Magill-Parker-King, *A Summary of the British Tax System*, November, 1934, 20. May, *The Influence of Accounting on the Development of an Economy* (1936) 15. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, 361. Krohn, "Taxation of Capital Profits and Stock Dividends," *Journal of Accountancy*, August, 1920, 89. Newlove-Smith-White, *op. cit.*, p. 61. Smith, "Capital Gains and Losses in Accounting," *Accounting Review*, June, 1939, 130.

4—Staub and Bell, "The Disposition in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants*, January, 1933, 7.

5—*Ibid.*, 9.

6—Newlove-Smith-White, *op. cit.*, 357.

7—See page 61 of this chapter for a possible denial of the latter two of these classifications.

8—Perhaps something can be done on this matter, however, because formerly the same sort of objection was raised against depreciation provisions.

9—See Chapters III and page 72 of this chapter.

10—Krohn, "Taxation of Capital Profits and Stock Dividends," *Journal of Accountancy*, August, 1920, 88.

11—Newlove-Smith-White, *op. cit.*, 295. The authors consider this objectionable because not conservative.

12—*Ibid.*, 357. Stempf, "A Critique of the Tentative Statement of Accounting Principles," *Accounting Review*, March, 1938, 59, 61. Staub and Bell, "The Dis-

position in the Accounts of Abnormal Losses," *Bulletin of the New York State Society of Certified Public Accountants*, January, 1933, 19.

13—Haig, *The Federal Income Tax* (1921) 24: Since accounting does not seem able to revalue assets successfully each period, we should give apportionment a trial. "A scheme of arbitrary apportionment of the gain over the period of accrual would be infinitely superior to the present practice."

14—Seligman, "Are Stock Dividends Income?" *American Economic Review*, September, 1919, 517.

15—See Chapter III for a more extended discussion.

16—1924, Sec. 203; Reg. 65, Art. 1571. 1938, Reg. 101, Art. 111-1.

17—1924, Reg. 65, Art. 1561.

18—*Ibid.*

19—1926, Reg. 69, Art. 1561. 1938, Reg. 101, Art. 111-1.

20—Clader, "Peculiarities of Our Federal Taxes," *Journal of Accountancy*, May, 1936, 332.

21—34 Fed. 601 (1888) (quoted by Smith, *Economic, Accounting, Legal Aspects of Capital Gains and Losses*, 1937 (Theses), 58.

22—1918, Reg. 45 (1920 ed.) Art. 48. 1938, Reg. 101, Art. 22(a) 13.

23—The lessor was permitted a deduction for depreciation based on the value of the improvement reported as income.

24—Cryan v. Wardell, 263 F. 248 (1920).

25—Hewitt Realty Company v. Commr., 76 F. 2d 880 (1935).

26—Hilgenberg v. U.S., 21 Fed. Supp. 453 (1937).

27—English v. Bitgood, 21 Fed. Supp. 641.

28—Staples v. U.S., 21 Fed. Supp. 737 (1937).

29—59 S. Ct. 186 (1938).

30—U. S. v. Phellis, 257 U.S. 156 (1921).

31—Johanna Hailman, Memo. BTA., April 17, 1939.

32—1913, II(B).

33—1913, II(B). 1916, Sec. 4. 1917, Sec. 1200.

34—Senate Finance Committee, 65th Congress, 3d Session, Senate Report 617, 6.

35—Conference Committee, 65th Congress, 3d Session, House Report 1037, 48.

36—1921, Sec. 213(b)(1); Reg. 62 (1922 ed.) Art. 72, 294.

37—Ways and Means Committee, 67th Congress, 1st Session, House Report 350, 10.

38—1924, Sec. 213(b)(1); Reg. 65, Art. 72, 293. 1938, Sec. 22(b)(1); Reg. 101, Art. 24-3.

39—1934, Reg. 86, Art. 22(b)(1)-1. 1936, Reg. 94, Art. 22(b)(1)-1. 1938, Reg. 101, Art. 22(b)(1)-1.

40—1918, Sec. 211(b).

41—Senate Finance Committee, 65th Congress, 3d Session, Senate Report 617, 6.

42—1921, Sec. 211(b). 1932, Sec. 102(a).

43—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 25.

44—1936, Sec. 105. 1938, Sec. 105.

45—Senate Finance Committee, 74th Congress, 2d Session, Senate Report 2156, 18 (1934).

46—1916-1917, Reg. 33, Art. 117.

47—1918, Reg. 45 (1920 ed.) Art. 43.

48—1921, Reg. 62 (1922 ed.) Art. 43. 1938, Reg. 101, Art. 22(a)-11.

49—See Chapter IV for a general discussion of the "installment sales" method for income determination.

50—1918, Reg. 45 (1920 ed.) Art. 45. 1938, Reg. 101, Art. 44-3.

51—1926, Reg. 69, Art. 45. 1928, Reg. 74, Art. 353. 1932, Reg. 77, Art. 353.

52—1918, Reg. 45 (1920 ed.) Art. 45. 1921, Reg. 62 (1922 ed.) Art. 45. 1924, Reg. 65, Art. 45.

53—1932, Reg. 77, Art. 353.

54—1934, Reg. 86, Art. 44-3. 1936, Reg. 94, Art. 44-3.

55—1938, Reg. 101, Art. 44-3.

56—1928, Reg. 74, Art. 355.

57—1932, Reg. 77, Art. 355. 1938, Reg. 101, Art. 44-5.

58—1918, Reg. 45 (1920 ed.) Art. 153.

59—1926, Reg. 69, Art. 153, added: ". . . (to the extent that it constitutes capital or represents an item the income from which has been returned by him)."

60—1926, Reg. 69, Art. 153, used "creditor" instead of "taxpayer."

61—1921, Reg. 62 (1922 ed.) Art. 153. 1924, Reg. 65, Art. 153.

62—1926, Reg. 69, Art. 153. 1938, Reg. 101, Art. 23 (k)-3.

63—See footnote 59.

64—Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216 (1937).

65—1918, Reg. 45 (1920) ed.) Art. 40. 1938, Reg. 101, Art. 22(a)-9, 111-1, 113(a)(14)-1, 113(b)-1, 113(b)-2.

66—1918, Reg. 45 (1920 ed.) Art. 41. 1938, Reg. 101, Art. 22(a)-1, 111-1, 113(a)(14)-1, 113(b)-1, 113(b)-2.

67—1934, Sec. 117(f). 1936, Sec. 117 (f). 1938, Sec. 117(f).

68—1918, Reg. 45, Art. 1563. Mimeo. 3166. I.T. 2216. I.T. 2347. I.T. 3056, C.B., 1937-1, 101.

69—1916, Reg. 33, Art. 158. 1917, Reg. 33, Art. 158.

70—Kester, *Accounting Theory and Practice,* II (1920) 412.

71—Hatfield, *Accounting* (1927) 96-99.

72—*Ibid.,* 302.

73—*Ibid.,* 98. Finney, *Principles of Accounting,* I (1929) Ch. 30, p. 3 Newlove-Smith-White, *op. cit.,* 146. Kester, *Accounting Theory and Practice,* II (1920) 412.

74—1913, II (B). 1916, 5(a) 6th, 6(a) 6th. 1918, Sec. 234(a)(5).

75—1913, II (B).

76—Quadrica Mfg. Co., BTA 928, Docket 2814.

77—Reserve for bad debts not allowed under the 1918 Act: Farmers Hardware Co., 2 (1925) BTA 90. R.I. Hospital Trust, 8 (1927) BTA 555.

78—1916-1917, Reg. 33, Art. 151.

79—1921, Sec. 234(a)(5); also see Reg. 62 (1922 ed.) Art. 155. Also see: T.D. 3262, Dec. 21, 1921, C.B., June, 1922, 152.

80—Ways and Means Committee, 67th Congress, 1st Session, House Report 350, 11.

81—1924, Sec. 234(a)(5); Reg. 65, Art. 155. 1938, Sec. 23(k); Reg. 101, Art. 23(k)-1, 5.

82—1918, Reg. 45 (1920 ed.) Art. 152.

83—1921, Reg. 62 (1922 ed.) Art. 152. 1938, Reg. 101, Art. 23(k)-2.

84—C. A. Collin, 1 (1924-25) BTA 305. Searles R. E. Trust, 25 (1931-32) BTA 1115. And others.

85—C. Peterson, 1 (1924-25) BTA 690. Russell Wheel & Foundry Co., 3 (1925-26) BTA 1168. Pacific Novelty Co., 5 (1926-27) BTA 1017.

86—O. O. 297, C.B., 1919, 126.

87—American Felt Co., v. Burnet, 58 F. 2d 530; Affing, 18 (1929-30) 504, 509.

88—Porter v. U.S., 20 F. 2d 935.

89—See discussion of security losses as bad debts.

90—First National Bank of Durant, Oklahoma, 6 (1927) BTA 545. Alexander County National Bank, 12 (1928) BTA 1238.

91—Spring City Foundry Co. v. Commr., 292 U.S. 182.

92—1936, Reg. 94, Art. 23(k)-5.

93—Ewald and Co., 18 (1929-30) BTA 1130. Poll & Kelly, 19 (1930) BTA 1317. Dillon Supply Co., 20 (1930) BTA 404. Fairmount Home F. Co., 23 (1931) BTA 909.

94—Chas. A. Collins, 1 (1924-25) BTA 305. Stephenson v. Commr., 43 F. 2d 348. Jones et al. v. Commr., 38 F. 2d 550; reversing 14 (1928-29) BTA 729.

95—R. I. Hospital Trust Co., 8 (1927) BTA 555. Frank Sons Co., 22 (1931) BTA 40. And others.

96—R. I. Hospital Trust Co. v. Commr., 29 F. 2d 339. H. Kahn, 17 (1929) BTA 499. National Mill Supply Co., 23 (1931) BTA 1362. First Nat'l. Bank of Omaha v. Commr., 49 F. 2d 70.

97—G.C.M., 938-A, C.B., December, 1927, 206.

98—1917, Reg. 33, revised; "Income Tax Department," *Journal of Accountancy*, April, 1918, 270. 1918, Reg. 45 (1920 ed.) Art. 151.

99—H. E. Baumer v. Heiner, U.S. Dist. Ct., Pennsylvania. Santa Monica Mountain Park Co., v. U.S., 99 F. 2d 450. Peerless Oil & Gas Co. v. Heiner, 12 Fed. Supp. 232; Affd. 81 F. 2d 391.

100—See footnote 97.

101—1913, Reg. 33, Art. 125.

102—1921, Sec. 234(a)(5); Reg. 62 (1922 ed.) Art. 155.

103—Stieglitz, Treiher Co., 1 (1924-25) BTA 452. The American Fork & Hoe Co., 33 (1935-36) BTA 1139. Clark v. Commr., 85 F. 2d 622. And others. But see: McMillan, Trustee v. U.S., 84 Ct. Cl. 580; 84 Ct. Cl. 631. Hoover, et al., Exec. v. U.S. 84 Ct. Cl. 631.

104—G.C.M. 18525, C.B., 1937-1, 80. Freeman-Dent-Sullivan Co. v. U.S., 21 F. Supp. 972.

105—1918, Reg. 45 (1920 ed.), Art. 154. 1936, Reg. 94, Art. 23(k)-4.

106—See page 101 for a discussion of worthless capital stock.

107—1921, Reg. 62 (1922 ed.) Art. 154.

108—Merritt J. Corbett, 15 (1929) BTA 698. Commonwealth Commercial State Bank v. Lucas, 41 F. 2d 111.

109—First National Bank of St. Paul, 10 (1928) BTA 32.

110—Ways and Means Subcommittee, 75th Congress, 3d Session, House Report, Jan. 14, 1938, 44-46. Ways and Means Committee, 75th Congress, 3d Session, House Report 1860, 18-19.

111—Senate Finance Committee, 75th Congress, 3d Session, Senate Report 1567, 13-14.

112—1938, Reg. 101, Art. 23(k)-4.

113—I. T. 3121 (1937) XVI-40-8952; American Institute of Accountants Committee on Federal Taxation, "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 305.

114—1916-17, Reg. 33, Art. 110.

115—Hartford Hat & Cap Co., 7 (1927) BTA 714. Putnam National Bank v. Commr., 50 F. 2d 158; aff. 20 (1930) BTA 45. Lake View Trust & Savings Bank, 27 (1932-33) BTA 290. And others.

116—G.C.M. 20854 (1939).

117—Huning Mercantile Co., 1 (1924-25) BTA 130. S. R. 2940, C.B., June, 1925, 129.

118—A.R.R. 1446, C.B., June, 1923, 96. Forth Worth Warehouse & Storage Co., 6 (1927) BTA 536. Ed. S. Hughes, 6 (1927) BTA 949. Iberville Wholesale Grocery Co. Ltd., 17 (1929) BTA 235.

119—The Sawyer Lanning Co. v. C. J. O'Keefe Shoe Co., 23 F. 2d 717.

120—Newlove-Smith-White, *op. cit.* (1939) 149.

121—1918, Reg. 45 (1920 ed.) Art. 51. 1932, Reg. 77, Art. 64.

122—1934, Reg. 86, Art. 12(a)-14. 1936, Reg. 94, Art. 12(a)-14. 1938, Reg. 101, Art. 12(a)-14.

123—U.S. v. Kirby Lumber Co., 284 U.S. 1, 52 S.Ct. 4 (1931). Helvering v. American Chicle Co., 291 U.S. 426, 54 S.Ct. 460 (1933). F. A. Douty, 9 (1927-28) BTA 398. Twin Ports Bridge Co., 27 (1932-33) BTA 346. E. F. Simms, 28 (1933) BTA 988. Carlisle Packing Co., 29 (1933-34) BTA 514. Lakeland Grocery Co., 36 (1937) BTA 289. Commr. v. Simmons Gin Co., 43 Fed. 2d 327.

124—I.T. 2195, C.B., December, 1925, 36. I.T. 2406, C.B., June, 1928, 68. Des Moines Improvement Co., 7 (1927) BTA 279.

125—Nonacq., C.B., June, 1934, 21. I.T. 2771, C.B., June, 1934, 200 (revoked I.T. 2195). I.T. 2772, C.B., June, 1934, 212 (revoked I.T. 2406).

126—Meyer Jewelry Company, 3 (1925-26) BTA 1319. Burnet v. J. F. Campbell Company, 50 F. 2d 487, aff. 15 (1929) BTA 458. Towers and S. Mfg. Co., 25 (1931-32) BTA 922. Bowers v. Kerbaugh-Empire Co., 70 L.Ed. 518, 46 S.Ct. 449 (1925). And others.

127—284 U.S. 1, 52 S.Ct. 4, reversing 71 Ct. Cl. 290.

128—American Wringer Co. v. U.S., 15 Am. Fed. Tax Reports 738. Woodward Iron Co., 24 (1931) BTA 1050. Suncrest Lumber Co., 25 (1931-32) BTA 375. (Nonacq., C.B., June, 1932, 11.) Norfolk Southern R.R. Co., 25 (1931-32) BTA 925.

129—4 (1926) BTA 870; 6 (1927) BTA 436; 6 (1927) BTA 1364; 7 (1927) BTA 577; 11 (1928) BTA 541; 12 (1928) BTA 436; 14 (1928-29) BTA 105; 17 (1929) BTA 787; 18 (1929-30) BTA 418; 20 (1930) BTA 586; 20 (1930) BTA 591; 21 (1930-31) 864; 23 (1931) BTA 177; and 24 (1931) BTA 197. In all of these cases the Commissioner refused to acquiesce.

130—1916-1917, Reg. 33, Art. 152.

131—70 F. 2d 95, reversing 27 (1932-33) BTA 651.

132—In the Kirby case the court said: "Here there was no shrinkage of assets and the taxpayer made a clear gain."

133—Nelson, "Capital Gains and Losses," *Tax Magazine*, December, 1936; *The Accountants Digest*, December, 1937, Vol. 3, No. 2.

134—*La Salle Manual of Federal Income Tax Procedure* (1939) 178. "The rules set up in the Regulations regarding the purchase and retirement by a corporation of its own bonds are no different from what would be found in any good accounting textbook."

135—See footnote 132.

136—See footnotes 127-130.

137—"Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 305.

138—Bankruptcy Act of 1898; amended June 22, 1938; Sec. 268; Public, No. 696, 75th Congress.

139—Ibid., Sec. 269.

140—"Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 305.

141—1939, Sec. 22(b)(9); Sec. 215.

142—For income tax purposes a gain measured by the excess of the amount received on the disposition of the gift over its basis when received would be treated as income.

143—Haig, *The Federal Income Tax* (1921) 26. Simons, *Personal Income Taxation* (1938) (cited by McLaren, *Journal of Accountancy*, April, 1938, 356.).

144—Seligman, *The Income Tax* (1921) 20, 514.

145—1918, Sec. B. 1938, Sec. 22(b)(3); Reg. 101, Art. 22(b)(3)-1.

146—E. C. Taft v. Bowers, Coll.; G. C. Greenway, Jr. v. Bowers, Coll.; (1921 Act); "Income Tax Department," *Journal of Accountancy*, Oct., 1926, 288. Texas & Pacific R.R. Co. v. U.S., 52 F. 2d 1040 (1931).

147—"Tax-avoidance" is beyond the scope of this study. For an interesting discussion of the subject, see: Seideman, *Legislative History of Federal Income Tax Laws* (1938) 335.

148—Letter from the Secretary of the Treasury, read in House discussion, Congressional Record, Vol. 78.

149—Ways and Means Subcommittee, 73d Congress, 2d Session, House Report, Dec. 4, 1933, regarding Section 112 of the income tax law.

150—*Ibid.*

151—*Ibid.*

152—*Ibid.*

153—*Ibid.*

154—Ways and Means Committee, 73d Congress, 2d Session, House Report 704.

155—*Ibid.*: "The Treasury Department states that its experience indicates that this provision does not in fact result in tax avoidance. If all exchanges were made taxable, it would be necessary to evaluate the property received in exchange . . . , and for the time being, at least, claims for theoretical losses would probably exceed any profits which could be established. The committee does not believe that the net revenue which could thereby be collected, particularly in these years would justify the additional administrative expense."

156—1918, Sec. 202(b). 1926, Sec. 202 (c).

157—1923, Sec. 202 (c). 1938, Sec. 112(c)(1).

158—Newlove-Smith-White, *op. cit.*, 242-3: "It appears to be sound, although it is not accepted by some accountants. The method should always be used of course, when no established market value for the new asset is available."

159—*Ibid.*, 242.

160—See page 105.

161—Commr. v. W. H. Hartman, 20 (1930) BTA 302.

162—Cooper Brannan Naval Stores Co., 9 (1927-28) BTA 105. W. G. Kay, 10 (1928) BTA 534.

163—"Investment" was eliminated by the Senate Finance Committee but restored by the Conference Committee.

164—1921, Sec. 202(c)(1).

165—7 (1927) BTA 588; 8 (1927) BTA 408; 10 (1928) BTA 705; 10 (1928) BTA 1015; 14 (1928-29) BTA 1084; 14 (1928-29) BTA 1153; 15 (1929) BTA 1225; 20 (1930) BTA 302; 21 (1930-31) BTA 144; 21 (1930-31) BTA 1078.

166—House Discussion, Congressional Record, Vol. 64. But see: 1918, Reg. 45, Art. 1564.

167—*Ibid.*

168—Amended March 4, 1923, effective January 1, 1923.

169—Senate Finance Committee, 68th Congress, 1st Session, Senate Report 398.

170—1924, Sec. 203(b)(1); Reg. 65, Art. 1572. 1938, Reg. 101, Art. 112(b)(2)-1.

171—1921, Sec. 202(c)(3); Reg. 62, Art. 1566. 1938, Sec. 112 (b)(5); Reg. 101, Art. 112 (b)(5)-1.

172—1918, Reg. 45 (1920 ed. Art.) 50.

173—Congressional Discussion (House) Cong. Rec. Vol. 61, 5296 (1921).

174—1921, Sec. 234(a)(14).

175—Ways and Means Committee, 68th Congress, 1st Session, House Report 179, 13-14.

176—1924, Sec. 203(b)(5); Reg. 65, Art. 1579. 1938, Sec. 112(f); Reg. 101, Art. 112(f)-1.

177—Cotton. Con. Co., 4 (1926) BTA 1121.

178—See also Sections 371 and 372 (1938) for details and limitations of this provision.

179—1939, Sec. 373(a); Sec. 221.

180—Ways and Means Committee, 68th Congress, 1st Session, House Report 179, 15.

181—1924, Sec. 203(f); Reg. 65, Art. 1573. 1926, Sec. 203(f); Reg. 69, Art. 1573. 1928, Sec. 112(e); Reg. 74, Art. 573. 1932, Sec. 112(e); Reg. 77, Art. 573. 1934, Sec. 112(e); Reg. 86, Art. 112(e)-1. 1936, Sec. 112(e); Reg. 94, Art. 112(e)-1. 1938, Sec. 112(e); Reg. 101, Art. 112(e)-1.

182—1916, Sec. 12(a). 1918, Sec. 234(a)(4).

183—Penn Co., 2 (1925) BTA 48. M. J. Corbett, 16 (1929) BTA 1231.

184—H. B. Clark, 2 (1925) BTA 555.

185—1924, Sec. 234(a)(4).

186—1926, Sec. 234(a)(4). 1938, Sec. 118; Reg. 101, Art. 118-1.

187—Ways and Means Committee, 72d Congress, 1st Session, House Report 708, 17.

188—For additional discussion regarding the inclusion of non-recurring items in the income calculation, see Chapters II and III and pages 59 to 62 of this chapter.

189—Kester, *Accounting Theory and Practice,* II (1920) 507-8. Securities and Exchange Commission, Accounting Release, April 1, 1937.

190—Couchman, "Classification of Surplus," *Journal of Accountancy,* Vol. 32, 1921, 267. Finney, *Journal of Accountancy,* Vol. 31, 1921, 390. Finney, *Principles of Accounting,* I (1923) Ch. 7, p. 14. Pinkerton, "The Classification of Surplus," *Administration,* Vol. 4, 589. Saliers, *The Accountants Handbook* (1st ed.) 306. Beckman, "Sources and Treatment of Surplus," *Journal of Accountancy,* Vol. 35, 1923, 348. Reiter, *Profits, Dividends and the Law,* 206. Montgomery, *Auditing Theory and Practice* (4th ed.) I, 374-5.

191—Finney, *Principles of Accounting,* I (1934) 45.

192—Daniels, *Corporation Financial Statements* (1934) 76. Smith, *Economic, Accounting, Legal Aspects of Capital Gains and Losses* (Thesis), 1937

193—Smith, *Economic, Accounting, Legal Aspects of Capital Gains and Losses* (Thesis) 1937, 44.

194—May, "Taxation of Capital Gains," *Journal of Accountancy,* November, 1922, 321, 331, 333. May, *The Influence of Accounting on the Development of an Economy* (1936) 20. Editorial, "Another Revenue Act Appears," *Journal of Accountancy,* June, 1936, 84. Cole, "Treatment of Capital Gains and Losses for Income

Tax Purposes," *Tax Magazine*, October, 1936, 583. Parker, "Capital Gains and Losses," Discussion before Institute of Public Affairs, University of Virginia, 1936. Editorial, "The Revenue Act of 1938," *Journal of Accountancy*, April, 1938, 275.

195—Magill-Parker-Kind, *Summary of the British Tax System* (1934) 57.

196—Haig, *The Federal Income Tax* (1921) 25. Smith, "Capital Gains and Losses in Accounting," *Accounting Review*, June, 1939, 126.

197—Haig, *Op. cit.* May, "Taxation of Capital Gains," *Journal of Accountancy*, November, 1922, 321.

198—May, "Taxation of Capital Gains," *Journal of Accountancy*, November, 1922, 323. Magill, Address before Womens Club (1934). Jackson, *Economics of the Revenue Act of 1935*, 203. American Institute of Accountants Committee on Federal Taxation, *Journal of Accountancy*, November, 1937, 360. Robinson, "A Reply to Recent Criticism of Capital Gains Tax, *The Annalist*, June, 1937. Hosmer, "The Effect of Direct Charges to Surplus on the Measurement of Income," *Accounting Review*, March, 1938, 44.

199—The matter is beyond the scope of this study and no investigation of statistics has been attempted.

200—Graves, *Questionnaire on Taxation*, 1937, cited by K. L. Smith, *Economic, Accounting, Legal Aspects of Capital Gains and Losses* (Thesis) 1937.

201—Cole, "Treatment of Capital Gains and Losses for Income Tax Purposes," *Tax Magazine*, October, 1936, 584.

202—American Institute of Accountants Committee on Federal Taxation, "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 305.

203—Editorial, *Journal of Accountancy*, January, 1937, 1. American Institute of Accountants Committee on Federal Taxation, *Journal of Accountancy*, November, 1937, 349. *Ibid.*, Recommendations to Senate Finance Committee, Report, September 23, 1937. *Ibid.*, "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 305.

204—Barr, *A Proposal for Certain Changes in the Federal Income Tax Law* (Thesis), 1924, 47, 48.

205—See other portions of this chapter for a discussion of this matter.

206—Chamberlain, "Adjustments of Fixed Assets," *Papers on Accounting Principles and Procedure 1938*, 8.

207—*Ibid.*

208—Stratton's Independence v. Howbert, 231 U.S. 399 (1913). Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918). Eisner v. Macomber, 252 U.S. 189 (1920). Merchants' Loan & Trust Co., v. Smietanka, 255 U.S. 509 (1921). Goodrich v. Edwards, 255 U.S. 527 (1921). Walsh v. Brewster, 255 U.S. 536 (1921).

209—Eisner v. Macomber, 252 U.S. 189 (1920).

210—Littleton, "High Standards of Accounting," *Journal of Accountancy*, August, 1938, 101: "Management may also have been innocently misled by an outmoded tradition, inherited by our accounting literature from certain early British ideas and never thoroughly examined, to the effect that there was something in a business by the name of capital assets in which losses and gains could be recognized as quite distinct from other asset changes called expenses and revenues."

"Whatever the origin may have been, there is little ground in America today for trying to relate fixed assets, any more than current assets, to capital stock investments after an enterprise has once been established. Since fixed assets are not directly tied into ownership capital, it is difficult to see how one kind of fixed asset diminution (loss) has more justification as a charge against capital or surplus than another kind of fixed asset diminution (depreciation)." Chamberlain. "Adjustments of Fixed Assets," *Papers on Accounting Principles and Procedure—1938*, 9.

211—Eisner v. Macomber, 252 U.S. 189 (1920). See other portions of this chapter also.

212—Price level changes are buried in ordinary, recurring incomes and losses also.

213—1916-17, Reg. 33, Art. 147.

214—1916-17, Reg. 33, Art. 101, 116.

215—1918, Reg. 45, Art. 545.

216—1921, Reg. 62 (1922 ed.) Art. 546. 1938, Reg. 101, Art. 22(a)-19.

217—1913, Reg. 33, Art. 109. 1916-17, Reg. 33, Art. 101, 116, 147. 1918, Reg. 45, Art. 545.

218—1921, Sec. 206(a)(6).

219—1924, Sec. 208(a)(8). 1932, Sec. 101(c)(8).

220—1934, Sec. 117(b); 1936, Sec. 117.

221—This change was suggested in 1937 by the American Institute of Accountants Committee on Federal Taxation, *Journal of Accountancy*, November, 1937, 349; January, 1937, 1.

222—1938, Sec. 117(a)(1).

223—"Recommendations for Amendment of the Federal Revenue Act," *Journal of Accountancy*, May, 1938, 383.

224—1932, Sec. 23(s).

225—1934, Sec. 117(e). 1936, Sec. 117(e). 1938, Sec. 117(g).

226—1934, Reg. 86, Art. 117(b).

227—Subject to some arbitrary limitations, however. They are discussed elsewhere in this chapter.

228—1921, Sec. 206(b).

229—1924, Sec. 208(b). 1932, Sec. 101.

230—For restriction on losses see the section of this chapter entitled: "Limitations on Capital Losses."

231—1934, Sec. 117. 1936, Sec. 117.

232—100%—not over one year. 80%—one year to two years. 60%—two years to five years. 40%—five to ten years. 30%—over ten years.

233—100%—not over eighteen months. 66-2/3%—eighteen to twenty-four months. 50%—over twenty-four months.

234—Smith, *Economic, Accounting, Legal Aspects of Capital Gains and Losses* (Thesis) 1937.

235—Ways and Means Committee, 1932, Revenue Revision Hearings, House Report, 72d Congress, 1st Session, 219.

236—1928.

237—First National Bank, 10 (1928) BTA 32. Commonwealth Fed. Sav. Bank, 13 (1928) BTA 467.

238—1938, Sec. 23(g)(2); Reg. 101, Art. 23(g)-1.

239—1921, Sec. 206(a).

240—1924, Sec. 208(c), 206(a)(2) 1932, Sec. 101(c), 117(a)(2).

241—1934, Sec. 117(d). 1936, Sec. 117(d).

242—1938, Sec. 117(d).

243—1939, Sec. 212.

244—Editorial, *Journal of Accountancy*, January, 1937, 1. American Institute of Accountants Committee on Federal Taxation, *Journal of Accountancy*, November, 1937, 349.

245—May, *The Influence of Accounting on the Development of an Economy* (1936) 21.

246—Jackson, Robert H., *Economics of the Revenue Act of 1935*, 202.

247—1932, Sec. 23(r).

248—1932, Sec. 23(t): " 'Stock and bonds' means (1) shares of stock in any corporation, or (2) rights to subscribe for or to receive such shares, or (3) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation (other than a government or political subdivision thereof), with interest coupons or in registered form, or (4) certificates of profit, or of . . ."

249—I.T. 2671, C.B., June, 1933, 41.

250—Effective as of January 1, 1933.

251—Ways and Means Committee, 72d Congress, 1st Session, House Report 708, 12-14. Senate Finance Committee, 72d Congress, 1st Session, Senate Report 665, 17-20.

252—*Ibid.*

253—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 23.

254—If "unrealized" appreciation were included in income, depreciation would have to be based on appreciated asset figures.

255—Seligman, "Are Stock Dividends Income?" *American Economic Review*, September, 1919, 517. Hatfield, *Accounting* (1927) 78.

256—Finney, *Principles of Accounting*, I (1929) Ch. 2, p. 10.

257—A more complete discussion is contained in Chapter X.

258—Kester, *Accounting Theory and Practice*, II (1920) 243. Hatfield, *Accounting* (1927) 87. Littleton, "Suggestions for the Revision of the Tentative Statement of Accounting Principles," *Accounting Review*, March, 1939, 59.

259—1913, Sec. G(b)(second); Reg. 33, Art. 113, 124, 158.

260—1913, Sec. B, fourth.

261—1916-1917, Sec. 12(a) second; Reg. 33, Art. 147.

262—1918, Sec. 234(a)(4); Reg. 45, Art. 141.

263—1921, Sec. 234(a)(4); Reg. 62, Art. 141, 146.

264—1924, Sec. 234(a)(4); Reg. 65, Art. 141. 1938, Sec. 23(f); Reg. 101, Art. 23(e)-1.

265—1913, Reg. 33, Art. 124.

266—1913, Reg. 33, Art. 111.

267—1916, Reg. 33, Art. 147. 1917, Reg. 33, Art. 147. 1918, Reg. 45, Art. 141.

268—1938, Reg. 101, Art. 23(e)-1.

269—1934, Reg. 86, Art. 111-1. 1936, Reg. 94, Art. 111-1. 1938, Reg. 101, Art. 111-1.

270—1916-17, Reg. 33, Art. 148. T.D. 2005, T.D. 2130, T.D. 2152. I.T. 1995, C.B., June, 1924, 145.

271—1916-17, Reg. 33, Art. 148. T.D. 2609.

272—1916-17, Reg. 33, Art. 148.

273—Gude Bros., Kieffer Co., 2 (1925) BTA 1029. M. J. Hellmers, 5 (1926-27) BTA 198. Schuman Piano Co., 10 (1928) BTA 118. A.R.R. 906, C.B., June, 1922, 143.

274—G.C.M. 12151, C.B., June, 1933, 115.

275—Krohn, "Taxation of Capital Profits and Stock Dividends," *Journal of Accountancy*, August, 1920, 88.

276—John E. Frymier, 5 (1926-27) BTA 758. The Davis Co., 6 (1927) BTA 281. Adams-Roth Baking Co., 8 (1927) BTA 458.

277—Martin Veneer Co., 5 (1926-27) BTA 207. American Multigraph Co., 10 (1928) BTA 406. Worstell Co., 15 (1929) BTA 413. But see, Pike City Coal Corp., 4 (1926)BTA 625.

278—Charles B. Bretzfelder, et al., 21 (1930-31) BTA 789.

279—A.R.R. 2503, C.B., December, 1923, 131. Peterson Linotyping Co., 10 (1928) BTA 542. Alabama Mineral Land Co., 28 (1933) BTA 586. Gottlieb Realty Co., 28 (1933) BTA 418. Montgomery v. U.S., 15 Am. Fed. Tax Rep. 865.

280—Geo. N. Crouse, 26 (1932) BTA 477.

281—U. S. v. S. S. White Dental Mfg. Co. of Pa., 274 U.S. 398, 47 S.Ct. 598.

282—O. 988, C.B., June, 1920, 84. A.R.R. 13, C.B., June, 1920, 78. O.D. 751, C.B., December, 1920, 116. A.R.M. 189, C.B., December, 1922, 68. J. T. Pittard, 5 (1926-27) BTA 929. Newaygo Portland Cement Co., 27 (1932-33) BTA 1097. American Land & Invest. Co., Ex., v. Commr., 40 Fed. 2d 336. Lucas v. North Texas Lumber Co., 281 U.S. 11, 50 S.Ct. 184; C.B., June, 1930, 294. And others.

283—77 Fed. 2d 446, affing, 30 (1934) BTA 659.

284—Such is true regarding non-recognized gains and losses on certain types of transactions, deductions for estimated future expenses, and similar uncertain items.

285—Among such concessions are the allowances for bad debts based on estimates and allowances for estimated normal obsolescence.

286—Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266. McQueen & Co. v. Commr., 67 Fed. 2d 857. Ahles Realty Corp. v. Commr., 71 Fed. 2d 150. Helvering v. Security Saving & Com. Bank, 72 Fed. 2d 874.

287—John C. Shaffer, 28 (1933) BTA 1293; (Nonacq., C. B. June, 1934, 29.

288—This discussion is not concerned with dealers in securities.

289—1918, Reg. 45 (1920 ed.) Art. 144. 1938, Reg. 101, Art. 23(b)-4.

290—*Ibid.*

291—Joslyn M. & S. Co., 6 (1927) BTA 749. S. G. Armstrong, 24 (1931) BTA 321. Van Diest v. U.S., 67 Ct. Cl. 655. And others.

292—G. H. Pearsall, 10 (1928) BTA 467. S. H. Goldberg, 36 (1937) BTA 44. DeLoss v. Blair, 28 F. 2d 803. Schmidlapp v. Commr., 96 F. 2d 680. And others.

293—Royal Packing Co. v. Commr., 22 Fed. 2d 536, rev. 5 BTA 55.

294—Albert Raiss, 21 (1930-31) BTA 593. Walter W. Moyer, 35 (1936-37) BTA 1155. Mary A. Blair v. U.S., 20 Fed. Suppl. 191.

295—1938, Sec. 23(g)(1), (2), (3).

296—1918, Reg. 45 (1920 ed.) Art. 143. 1932, Reg. 77, Art. 173.

297—1918, Reg. 45 (1920 ed.) Art. 143.

298—See page 95.

299—1934, Reg. 86, Art. 23(e)-3. 1936, Reg. 94, Art. 23(e)-3. 1938, Reg. 101, Art. 23(e)-3.

300—See pages 105-107.

301—Fleck, "The Incidence of Abandonment Losses," *Accounting Review*, June, 1926, 51.

302—*Ibid.*, 53.

303—*Ibid.*

304—Metro. Picture Film Exchange, 1 (1924-25) BTA 721. American Cigar Co., 21 (1930-31) BTA 464. Spear v. Heiner, 34 (F. 2d) 795. Ashland I. & M. Co. v. U.S., Ct. Cl., 56 F. 2d 466. And many others.

305—I.T. 2501, C.B., Dec., 1929, 116. C.D. 1031, C.B., Dec. 1921, 141. I.T. 1911, C.B., June, 1924, 147. Arthur H. Ingle, 1 (1924-25) BTA 595. Lansburgh & Porather, Inc., 23 (1931) BTA 66. Liberty Baking Co. v. Heiner, 34 F. 2d 513. And many others.

306—Providence Journal Co. v. J. V. Broderick, U.S. Dist. Ct. of Rhode Island.

307—1913, Reg. 33, Art. 127.

308—Chamberlain, "Adjustments of Fixed Assets," *Papers on Accounting Principles and Procedure—*1938, 8.

309—1916-17, Reg. 33, Art. 155.

310—1918, Reg. 45 (1920 ed.) Art. 142.

311—1921, Reg. 62 (1922 ed.) Art. 142. 1938, Reg. 101, Art. 23(e)-2.

312—Washington Catering Co., 9 (1927-28) BTA 743. R.C. Coffey, 21 (1930-31) BTA 1242.

313—Mandel Bros., 4 (1926) BTA 341.

314—Geo. H. Bowman Co., 7 (1927) BTA 399, affd. 32 F. 2d 404. Elmira Arms Co., 7 (1927) BTA 703. Guelph Hotel Corp., 7 (1927) BTA 1043.

315—Pig and Whistle Co., 9 (1927-28) BTA 668.

316—American Institute of Accountants, *Accounting Questions and Answers* (Pamphlet), Anwer #5, March, 1926, 46.

317—Blough, "The Relationship of the Securities and Exchange Commission to the Accountant," *Journal of Accountancy*, January, 1937, 38.

318—May, "Introduction," *Papers on Accounting Principles and Procedure—1938*, 1.

319—Editorial, "Pronouncements on Accounting Procedure," *Journal of Accountancy*, September, 1939, 145.

320—American Institute of Accountants, *Accounting Questions and Answers* (Pamphlet), Answer #1, March, 1931, 50.

321—*Ibid.*, Answer #1, June, 1936, 36.

322—*Ibid.*, Answer #2, June, 1936, 37. Staub, "Uniformity in Accounting," *Papers on Accounting Principles and Procedure—1938*, 4.

323—American Institute of Accountants, *Accounting Questions and Answers* (Pamphlet), Answer #2, June, 1936, 37.

324—T.D. 4603, C.B., December, 1935, 58.

325—The East Ninth Euclid Co., 26 (1932) BTA 32; 27 (1932-33) BTA 1289. Indiana Lamp Corporation, 28 (1933) BTA 491. American Gas & Electric Co., 33 (1935-36) BTA 471. Illinois Power & Light, 33 (1935-36) BTA 1189. Helvering v. California-Oregon Power Co., 75 F. 2d 644. Helvering v. Union Public Service Co., 75 F. 2d 723. Madison Avenue Offices, Inc. v. Anderson, 16 F. Supp. 548.

326—National Tile Co., 30 (1934) BTA 32 supports this rule.

327—Also see: I.T. 2347, C.B., June, 1927, 86. G.C.M. 9674, C.B., December, 1931, 354. Chicago Rock Island & Pacific Railway Co. v. Commr. 47 F. 2d 990. 375 Park Avenue Corp., 23 (1931) BTA 969. Pierce Oil Corporation, 32 (1935) BTA 403. Liquid Carbonic Corp., 34 (1936) BTA 1191.

328—Nowhere in this study is March 1, 1913 value to be treated.

329—H. N. Gifford, 3 (1925-26) BTA 334. Klamer-Goebel Furniture Co., 11 (1928) BTA 1322. Seaboard Air Line Railway Co. v. U.S. 67 Ct. Cl. 160. And others.

330—1918, Sec. 202(a); Reg. 45, Art. 1561. 1938, Sec. 113(a); Reg. 101, Art. 113(a)-1, 2, 113(a)(1)-1.

331—1921, Sec. 202(a); Reg. 62, Art. 1567.

332—1924, Reg. 65, Art. 1596. 1938, Reg. 101, Art. 113(a)(6)-1.

333—1918, Reg. 45, Art. 1564(b).

334—1921, Sec. 202(c); Reg. 62, Art. 1564.

335—1921, Sec. 202(d)(2); Reg. 62, Art. 1567(b).

336—1924, Sec. 204(a)(10); Reg. 65, Art. 1600. 1938, Sec. 113(a)(9); Reg. 101, Art. 113(a)(9)-1.

337—1921, Sec. 202(d)(3). 1938, Sec. 113(a)(10); Reg. 101, Art. 113(a)(10)-1.

338—Reorganizations are not considered in this study.

339—1924, Sec. 204(a)(8); Reg. 65, Art. 1598. 1938, Sec. 113(a)(8); Reg. 101, Art. 113(a)(8)-1.

340—Ways and Means Committee, 72d Congress, 1st Session, House Report 708, 21.

341—Rosenbloom Fin. Corp. v. Commr., 24 (1931) BTA 763.

342—1918, Reg. 45, Art. 1562.

343—1921, Sec. 202(a); Reg. 62, Art. 1563. 1938, Sec. 113(a); Reg. 101, Art. 113(a)(2)-1.

344—*Ibid.*

345—1934, Reg. 86, Art. 113(a)(2)-1. 1936, Reg. 94, Art. 113(a)(2)-1. 1938, Reg. 101, Art. 113(a)(2)-1.

346—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 27.

347—1934, Sec. 113 (a)(2).

348—*op. cit.*, footnote 352.

349—*Ibid.*

350—There have been some exceptions to this rule since 1928.

351—"Period of Affiliation" means the period during which the corporations were affiliated but does not include (1) any tax year beginning on or after January 1, 1922, unless a consolidated return was filed, nor (2) any tax year after the tax year of 1928.

352—1928, Reg. 74, Art. 603.

353—1932, Reg. 77, Art. 603. 1938, Reg. 101, Art. 113(a)(11)-1.

354—Ways and Means Committee, 68th Congress, 1st Session, House Report 179 (1924) 16-17.

355—1939, Sec. 113(b)(3).

356—1924, Sec. 202(b); Reg. 65, Art. 1561. 1938, Sec. 113(b); Reg. 101, Art. 111-1, 113(b)-1.

357—*Ibid.*

358—Depletion prior to 1932 shall not exceed the amount of diminution computed without reference to discovery value or percentage depletion.

359—1926, Reg. 69, Art. 1561. 1928, Reg. 74, Art. 561.

360—1928, Reg. 74, Art. 561.

361—1918, Sec. 202(a); Reg. 45, Art. 1561. 1938, Sec. 113(a); Reg. 101, Art. 113(a).

362—Senate Finance Committee, 67th Congress, 1st Session, Senate Report 275.

363—1924, Sec. 202(b).

364—1918, Reg. 45, Art. 1563. 1921, Reg. 62, Art. 1561, 1564.

365—By an investor, not by the issuing corporation.

366—Towne v. McElligott, 274 Fed. 960. G. W. Megeath, 5 (1926-27) BTA 1274.

367—D. Stewart, 17 (1929) BTA 604. Securities Co., 25 (1931-32) BTA 446. Skinner v. Eaton, 45 F. 2d 568, affing. 34 (1936) BTA 575. Helvering v. Rankin, 295 U.S. (1935) 123. Miller v. Commr., 80 F. 2d 219. And others.

368—Newlove-Smith-White, *Intermediate Accounting* (1939) 203. American Institute of Accountants Committee on Federal Taxation, "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 318. "Federal Tax Revision Program," *Journal of Accountancy*, November, 1939, 318.

369—Staub, "Uniformity in Accounting," *Papers on Accounting Principles and Procedure*—1938, 6.

370—1918, Reg. 45 (1920 ed.) Art. 39. 1938, Reg. 101. Art. 22(a)-8.

371—1918, Reg. 45 (1920 ed.) Art. 39.
372—Substituted in 1936.
373—1921, Sec. 201(c).
374—1921, Sec. 201(c). 1938, Sec. 115(d).

NOTES—CHAPTER VI

1—Husband, "The Corporate-Entity Fiction and Accounting Theory," *Accounting Review*, September, 1938, 252.

2—U.S. v. Milwaukee Refrigeration Transit Co., 142 Fed. 247.

3—Majestic Co. v. Orpheum Circuit, Inc., 21 F. 2d 720 (1927).

4—Industrial Research Corporation v. General Motors Corporation, 29 F. 2d 623.

5—Husband, *op. cit.*, 242.

6—1938, Sec. 401-411, surtax on personal holding companies, 1918, Reg. 45, Art. 351.

7—National Industrial Conference Board, *State and Local Taxation of Business Corporations*, (1931).

8—National Tax Association, *Report of Committee on the Federal Income Tax*, August, 1915, 4.

9—Berle and Means, *The Modern Corporation*, Book II, 279. Paton, *Accounting Theory* (1922), 67, 74, 76.

10—Paton, *Accounting Theory* (1922), 76. Robinson, "Are Present Forms of Financial Statements Satisfactory?" *Journal of Accountancy*, December, 1936, 426.

11—Paton, *op. cit.*, 62-64.

12—Husband, *op. cit.*, 253.

13—1916-17, Reg. 33, Art. 97, 145. 1938, Reg. 101, Art. 22 (a)-16.

14—Hatfield, *Accounting* (1927), 186, 204. Finney, *Principles of Accounting*, I, (1929), Ch. 8, 3.

15—McCoy-Garton Realty Co., 14 (1928-29) BTA 853. Carter Hotel Co., 25 (1931-32) BTA 933.

16—Illinois Rural Credit Assn. Appeal, 3 (1925-26) 1178. Commr. v. Inland Fire Co., 63 F. 2d 886, affing. 23 (1931) BTA 199. The Realty Bond & Mtg. Co. v. U.S., 83 Ct. Cl. 650.

17—1918, Reg. 45, Art. 543. 1938, Reg. 101, Art. 22(a)-17.

18—O.D. 795, C.B., June, 1921, 155. O.D. 918, C.B., June, 1921, 213. A.R.R. 588, C.B., Dec., 1921, 135. A.R.R. 1757, C.B., June, 1923, 93. I.T. 1751, C.B., Dec., 1923, 142. S.M., 2611, C.B., Dec., 1924, 160. I.T. 2777, C.B., June, 1934, 57. 2 (1925) BTA 484. 27 (1932-33) BTA 1043. And many others.

19—I.T. 2843, C.B., June, 1935, 77. (Re. closed bank.) Modifies I.T. 2617, C.B., June, 1932, 29. C. H. White, 15 (1929) BTA 1375. Geo. H. Stanton, 36 (1937) BTA 112. Estate G. A. E. Kohler, 37 (1938) BTA 1019.

20—Commr. v. Rosenbloom Fin. Corp., 66 Fed. 2d 556.

21—1918, Reg. 45 (1920 ed.) Art. 51. 1938, Reg. 101, Art. 22(a)-14.

22—U.S. v. Oregon-Washington R. & Nav. Co., 251 Fed. 211. Smith Insurance Service, Inc., 9 (1927-28) BTA 284. Ransom E. Olds, 18 (1929-30) BTA 1215.

23—1916-17, Reg. 33, Art. 98.

24—Letter of Feb. 7, 1916, "Income Tax Department," *Journal of Accountancy*, April, 1916, 290.

25—1916-1917, Reg. 33, Art. 99.

26—1918, Reg. 45, Art. 542, 563. 1932, Reg. 77, Art. 66, 176.

27—1934, Reg. 86, Art. 22(a)-16. 1936, Reg. 94, Art. 22(a)-16. 1938, Reg. 101, Art. 22(a)-16.

28—I.T. 1802, C.B., Dec., 1923, 267. A.R.R. 693, C.B., Dec., 1921, 207. Simmons & Hammond Mfg. Co., 1 (1924-25) BTA 803. (Overruled by 35 BTA 949, which was in turn overruled by 97 F. 2d 302.) Schiller Piano Co., 23 (1931) BTA 376. Jewel Tea Co. v. U.S., 90 F. 2d 451. Commr. v. Reynolds Tobacco Co., 305 U.S. 110. Helvering v. R. J. Reynolds Tob. Co. (1928 Act.) 97 F. 2d 302, (upheld by Sup. Ct., Jan. 30, 1939,) reversing 35 BTA 949. National Home Owners Service Corp. v. Commr., 39 (1939) BTA 101, (1934 Act.) And others.

29—O.D. 852, C.B., June, 1921, 286.

30—Haskell & Barker Car Co., 9 (1927-28) BTA 1087.

31—G.C.M. 16651, C.B., Dec., 1936, 130.

32—35 (1936-37) BTA 949.

33—97 F. 2d 302.

34—G.C.M. 12955, C.B., June, 1934, 107. S. A. Woods Machine Co. v. Commr., 57 F. 2d 635, reversing 21 BTA 818. Spear & Co. v. Heiner, 54 F 2d 134, affd. 61 F. 2d 1030. Johnson v. Commr., 56 F. 2d 58. Walville Lumber Co. v. Commr., 35 F. 2d 445.

35—Houghton & Dutton Co., 26 (1932) BTA 52.

36—Finney, *Principles of Accounting*, I (1929), Ch. 8, 16. May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, 333. Husband, "Accounting Postulates: An Analysis of the Tentative Statement of Accounting Principles," *Accounting Review*, Dec., 1937, 397, 398. American Institute of Accountants, Committee on Accounting Procedure, "Profits or Losses on Treasury Stock," *Journal of Accountancy*, Aug., 1938, 113. York, "Correspondence Section," *Journal of Accountancy*, Aug., 1938, 113. Broad, "Some Comments on Surplus Account," *Journal of Accountancy*, Oct., 1938, 215. Watson, "Principles Related to Treasury Stock," *Papers on Accounting Principles and Procedure—1938*, 35.

37—American Institute of Accountants, *Accounting Questions and Answers* (1937), Answer #1, 62, March, 1935.

38—S.E.C. Release, May 10, 1938, "Notes of the North," *Journal of Accountancy*, June, 1938, 499.

39—Montgomery, "Dealings in Treasury Stock," *Journal of Accountancy*, June, 1938, 466.

40—*Ibid.*, 474.

41—York, *op. cit.*

42—Montgomery, *op. cit.*, 473-4.

43—1916-17, Reg. 33, Art. 105; Sec. 1(b). 1926, Reg. 69, Art. 541. See pages 122-128 of this chapter for limitations.

44—1916-1917, Sec. 2a; Reg. 33, Art. 106.

45—1918, Sec. 201(a); Reg. 45, (1920 ed.), Art. 1541, 1544.

46—1921, Sec. 201(a); Reg. 62 (1922 ed.), Art. 1541. 1934, Sec. 115(a); Reg. 86, Art. 115-1.

47—1936, Sec. 115(a), Reg. 94, Art. 115-1. 1938, Sec. 115(a); Reg. 101, Art. 115-1.

48—Ways and Means Committee, 74th Congress, 2d Session, House Report, March 26, 1936, 56. Senate Finance Committee, 74th Congress, 2d Session, Senate Report 2156, 18.

49—But see: Roy J. Kinmear, 36 (1937) BTA 153, 95 F 2d 1007 (1932 Act). Husband, "The Corporate-Entity Fiction and Accounting Theory," *Accounting Review*, Sept., 1938. Stempf, "New Factors in Federal Income Taxation," *Journal of*

Accountancy, Oct., 1936, 245. A corporation has no earnings or profit available for dividends until the impairment of capital or paid-in surplus from operating losses has been made good.

50—1917, Sec. 1211.

51—Mason v. Routzahn, 275 U.S. 175, aff. 13 F. 2d 702. Kales v. Woodworth, 20 F. 2d 395. U.S. v. Stange, 43 F 2d 593, rev. 1 BTA 810. H. A. Moody, 9 (1927-28) BTA 631. A. J. Gifford, 18 (1929-30) 795. And others. Contra: N. W. Hendricks, 4 (1926) BTA 1257. M. E. Young, and others, 6 (1927) BTA 472.

52—1918, Sec. 201(b); Reg. 45, Art. 1541, 1542.

53—See footnote 61.

54—1916-17, Reg. 33, Art. 106.

55—Leland v. Commr., 60 F. 2d 523, aff. A. J. Gifford, 18 BTA 795. S. M. Bolster, 23 (1931) BTA 347.

56—In Harder v. Irwin, 285 Fed. 402, profits accumulated between the close of the preceding year and the date of distribution as well as prior to the year of distribution are included in "the most recently accumlated profits or surplus." See Douglas v. Edwards, 298 Fed. 229, for the opposite rule.

57—I. May, 20 (1930) BTA 282. Leland v. Commr., 50 F. 2d 523. S. M. Bolster, 23 (1931) BTA 347.

58—1918, Sec. 201(b); Reg. 45, Art. 1541, 1542.

59—1918, Sec. 201(b).

60—1921, Reg. 62, Art. 1542.

61—1921, Sec. 201(b); Reg. 62, Art. 1541, 1542. 1938, Sec. 115(b); Reg. 101, Art. 115-1, 2. 3.

62—See footnote 47.

63—Ways and Means Committee, 70th Congress, 1st Session, House Report 2, 20 (1928); 73d Congress, 2d Session, House Report 704, 15 (1934); 74th Congress, 2d Session, House Report, March 26, 1936, 5 (1936). Senate Finance Committee, 70th Congress, 1st Session, Senate Report 960, 1 (1928); 72d Congress, 1st Session, Senate Report 665, 30-31 (1932); 73d Congress, 2d Session, Senate Report 558, 36 (1934).

64—Letter, Feb. 12, House, Cong. Rec. Vol. 78, 2512.

65—1918, Sec. 201(c).

66—1924, Sec. 201(c). 1938, Sec. 115(c).

67—Ways and Means Committee, 68th Congress, 1st Session, House Report 179, 11, 12.

68—Ways and Means Subcommittee, 73d Congress, 2d Session, House Report, December 4, 1933, 18. Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 29-30.

69—Julius Rippel, 12 (1928) BTA 438. Marcus Frieder, et al., 27 (1932-33) BTA 1239. Eugenia R. Jemison, et al., 28 (1933) BTA 514. Lynch v. Hemby, 247 U.S. 339.

70—American Institute of Accountants, *Accounting Questions and Answers* (1937), July, 1932, Ans. #1, 114; Ans. #2, #3, 115. Madden, "Accountancy Has Valuable Contribution to Make to Law of the Land," *American Accountant*, March, 1928, 27. Kerrigan, "Corporate Distributions as Income to Stockholders," *Accounting Review*, Dec., 1938, 368.

71—Peabody v. Eisner, 247 U.S. 347. A dividend in shares of another corporation is taxable as a dividend in specie.

72—1916-17, Reg. 33, Art. 106.

73—1917, Sec. 1211. 1918, Sec. 201(c).

74—1921, Sec. 201(d); Reg. 62, Art. 1548, 1549.

75—Ways and Means Committee, 67th Congress, 1st Session, House Report 350, 8. Senate Finance Committee, 67th Congress, 1st Session, Senate Report 275, 9.

76—According to the decision in J. S. Bryan, 20 (1930) BTA 573, stock dividends were not subject to tax under the 1921 Act where *before* the distribution thereof the corporation cancelled or redeemed a part of its stock.

77—House Discussion, Cong. Rec. Vol. 65.

78—1924, Sec. 201(f); Reg. 65, Art. 1548, 1549. 1934, Sec. 115(f)(g); Reg. 86, Art. 115-8, 9.

79—House Discussion, Cong. Rec. Vol. 80, 6309-10.

80—1936, Sec. 115(f). 1938, Sec. 115(f).

81—1936, Reg. 94, Art. 115-7.

82—See Eisner v. Macomber (252 U.S., 189, T.D. 3010, C.B. 3, 25); and Koshland v. Helvering (56 Sup. Ct., 767 Ct. D. 1124, C.B. 5, 37); Compare United States v. Phellis (257 U.S. 156, T.D. 3270, C.B. 5, 37); Rockefeller v. United States (257 U.S., 176, T.D. 3271, C.B. 5, 34); Cullinan v. Walker (262 U.S., 134, T.D. 3508, C.B. II-2, 55); Weiss v. Stearn (265 U.S., 242, T.D. 3609, C.B. III-2, 51); and Marr v. United States (268 U.S., 536, T.D. 3755, C.B. IV-2, 116.)

83—T.D. 2274, Dec. 22, 1915, *Journal of Accountancy*, Vol. 4, 125. T.D. 2090, Dec., 1914 (reversed by T.D. 2163, Feb. 18, 1915.)

84—Gibbons v. Mahon, 136 U.S. 549 (1890). Towne v. Eisner, 245 U.S. 418 (reversing 242 Fed. 702.) This case was an interpretation of the 1913 Act, which had no specific provision regarding stock dividends. Eisner v. Macomber, 252 U.S. 189 (1920). This case was made necessary because the Commissioner did not feel that Towne v. Eisner applied to the 1916 Act, which specifically taxed share dividends. T.D. 3052, Aug. 4, 1920 (Following Eisner v. Macomber.) Walsh v. Brewster, 255 U.S. 536 (1921), affing. 268 Fed. 207. U.S. v. Phil. B. & W. R. Co., 262 Fed. 188. Loomis v. Wattles, 266 Fed. 876. Suddard v. Commr., 95 F. 2d 1017. Helvering v. Pfeiffer, 302 U.S. 247, 58 S. Ct. 157. Helvering v. Gowran, 303 U.S. 238, 58 S. Ct. 154. (Reversed 87 F. 2d 125, which reversed 32 BTA 820.)

85—Koshland v. Helvering, 298 U.S. 441 (1936). T.D. 4674, Aug. 8, 1936.

86—Horrman v. Commr., 34 (1936) BTA 180.

87—Alvord, "The Undistributed Profits Tax and Stock Dividends and Stock Rights," *Journal of Accountancy*, Dec., 1937, 419. See page 124 for the 1936 and 1938 provisions.

88—There is support for the opinion that the government might be able to tax corporation profits to shareholders just as is done with partnership profits and partners.

89—Montgomery, *Income Tax Procedure* (1918), 188. Kester, *Accounting Theory and Practice*, II (1920), 383. Paton, *Accounting Theory* (1922), 188. Hatfield, *Accounting* (1927), 212. Paton, *Accountants Handbook* (1935), 329. Kester, *Advanced Accounting* (1933), 506. Finney, *Principles of Accounting*, I (1934), 121. Montgomery, *Auditing Theory and Practice* (1934), 496. Himmelblau, *Complete Accounting Course*, II (1934), 181. Editorial, *Journal of Accountancy*, Vol. 59, 13 (1935). Newlove-Smith-White, *Intermediate Accounting* (1939), 215.

90—Hatfield, *op. cit.*, 212. Husband & Thomas, *Principles of Accounting* (1935), 419. Kerrigan, *op. cit.*, 376. Newlove-Smith-White, *op. cit.*

91—American Institute of Accountants, Special Committee, Letter to the New York Stock Exchange, Sept. 22, 1932, *Audit of Corporate Accounts* (1934), 18.

92—Haig, *The Federal Income Tax* (1921), 8, 9. Kerrigan, *op. cit.*, 371.

Peters, "Accounting for Hospital Investments," *Journal of Accountancy,* Sept., 1939, 187.

93—Husband, "The Corporate-Entity Fiction and Accounting Theory," *Accounting Review,* Sept., 1938, 243. Kerrigan, *op. cit.,* 370. Haig, *op. cit.,* 8, 10.

94—Paton, "Dividends in Securities," *Administration,* Vol. 4, 1922, 394.

95—Husband, *op. cit.,* 246.

96—Madden, "Accounting Has Valuable Contribution to Make to Law of Land," *American Accountant,* March, 1928, 25, 27. Kerrigan, *op. cit.,* 366; "Accounting for Stock Dividends Received," *Accounting Review,* June, 1938, 172.

97—Haig, *op. cit.,* 8. Paton, *Accounting Theory* (1922), 398. Kerrigan, "Corporate Distributions As Income to Stockholders," *Accounting Review,* Dec., 1938, 370, 371.

98—*Ibid.,* 370. Husband, *op. cit.,* 243.

99—Husband, *op. cit.,* 242.

100—1916-17, Reg. 33, Art. 115 grants such recognition, although A. C. James, 13 BTA 764 restricts such inclusion for determining the parent's income available for dividends. Newlove-Smith-White, *op. cit.,* 213.

101—Peabody v. Eisner, 247 U.S. 350.

102—T.D. 2740, June 24, 1918. T.D. 3052, Aug. 4, 1920. C. Owen, 3 (1925-26) BTA 905. E. A. Landreth Co., 11 (1928) BTA 1. H. L. Erlewine, 19 (1930) BTA 253.

103—T.D. 3170, April 28, 1921.

104—Paton, *op. cit.,* 398.

105—Paton, "Dividends in Securities," *Administration,* Vol. IV (1922), 396, 501.

106—No attempt is made in this study to discuss (1) the computation of profits on subsequent sales of dividend shares or stock rights or (2) the basis for such stock or rights.

107—1918, Reg. 45 (1920 ed.), Art. 1547. 1934, Reg. 86, Art. 111-1, 113(a)(12)-1, 115-8.

108—Miles v. Safe Deposit & Trust Co. of Baltimore, 259 U.S. 247.

109—88 F. 2d 559 (C.C.A., 1st, 1937).

110—Commr. v. Mayer, 86 F. 2d 593 (C.C.A., 7th, 1936).

111—House Discussion, Congr. Record, Vol. 53, 509.

112—1917, Sec. 4.

113—Senate Finance Committee, 65th Congress, 1st Session, Senate Report 103, 21.

114—1918, Sec. 234(a)(6). 1928, Sec. 23(p).

115—1932, Sec. 23(p).

116—1934, Sec. 23(p).

117—Senate Discussion, Cong. Record, Vol. 78, 6467.

118—1935, Sec. 102(b).

119—Ways and Means Committee, 74th Congress, 1st Session, House Report 1681, 7.

120—Ways and Means Subcommittee, 74th Congress, 2nd Session, House Report, Mar. 26, 1936, 5. Ways and Means Committee, 74th Congress, 2nd Session, House Report 2475, 8.

121—Senate Finance Committee, 74th Congress, 2nd Session, Senate Report 2156, 15.

122—1936, Sec. 26(b).

123—1938, Sec. 26(b).

124—A discussion of "adjusted net income" is beyond the scope of this study.

125—1926, Reg. 69, Art. 31. 1934, Reg. 86, Art. 22(a)-1.

126—1936, Reg. 94, Art. 22(a)-1.

127—1938, Reg. 101, Art. 22(a)-1.

128—1918, Reg. 45, Art. 53. 1938, Reg. 101, Art. 42-2.

129—Montgomery, "Accounting and the Concept of Income," *Lectures on Taxation* (1932), 61.

130—J. Griffiths, 15 (1929) BTA 252. Eakins v. U.S., 36 F. 2d 961.

131—Freeman, "The Statement of the Accounts of Holding Companies," *Journal of Accountancy*, Sept., 1914, 157. Editorial, *Journal of Accountancy*, Sept., 1915, 216. Kester, *op. cit.*, 510, 602, 473. Hatfield, *Accounting* (1927), 9. Carmen, "Intercorporate Relationships," *American Accountant*, April, 1932, 106. Editorial, *Journal of Accountancy*, Jan., 1937, 3. American Institute of Accountants, Committee on Federal Taxation, "Recommendations for Amendment of Federal Revenue Act," *Journal of Accountancy*, May, 1938, 386. Newlove-Smith-White, *op. cit.*, 212, 550. Werntz, "Some Problems to Parent Companies," *Journal of Accountancy*, June, 1939, 340. Editorial, "The Fortune Tax Round Table," *Journal of Accountancy*, June, 1939, 334. American Institute of Accountants, Committee on Federal Taxation, *Journal of Accountancy*, Nov., 1939, 305. Feldman, "Separate Accounting Basis v. Apportionment," *Journal of Accountancy*, Nov., 1939, 324, 328.

132—American Institute of Accountants, Committee on Federal Taxation, *Journal of Accountancy*, Nov., 1937, 361, 362.

133—Editorial, *Journal of Accountancy*, July, 1925, 37.

134—Beers, "Training Classes in the Income Tax Unit," *Accounting Review*, June, 1928, 178.

135—Kracke, "Consolidated Financial Statements," *Journal of Accountancy*, Dec., 1938, 373. Newlove-Smith-White, *op. cit.*, 550.

136—Stempf, "Consolidated Financial Statements," *Journal of Accountancy*, Nov., 1936, 358.

137—Sec. 20, 1933 Act, as amended. Sec. 13(b), 1934 Act.

138—Newlove-Smith-White, *op. cit.*, 551.

139—*Ibid.* Stempf, *op. cit.*, 358.

140—*Ibid.*

141—Werntz, *op. cit.*, 337.

142—The scope of this study precludes a complete discussion of intercompany and consolidation income computations. Therefore, no attempt is made to define "affiliation" or other special terms or to discuss the mechanics of consolidated income calculation.

143—1916, Reg. 33, Art. 125, 207, 208.

144—The Commissioner's regulations requiring consolidated returns for affiliated corporations in 1917 were held valid. National Candy Co. v. U.S., 67 Ct. Cl. 74.

145—1918, Sec. 240(a); Reg. 45, Art. 632.

146—Senate Finance Committee, 65th Congress, 3d Session, Senate Report 617, 8-9.

147—1921, Sec. 1331.

148—Senate Finance Committee, 67th Congress, 1st Session, Senate Report 275, 34.

149—Bowe-Burke Mining Co. v. Willcuts, 22 F. 2d 204.

150—Ways and Means Committee, 67th Congress, 1st Session, House Report

350, 14. Senate Finance Committee, 67th Congress, 1st Session, Senate Report 275, 19-20.

151—1921, Sec. 240(a); Reg. 62, Art. 632.

152—1921, Sec. 240(e).

153—1924, Sec. 240(a); Reg. 65, Art. 632. 1926, Sec. 240(a); Reg. 69, Art. 632.

154—1928, Sec. 142; Reg. 74, Art. 731.

155—1928, Sec. 141; Reg. 74, Art. 711.

156—Joint Committee on Internal Revenue Taxation, Report Nov. 15, 1927, Vol. I, 13-14, 63-66.

157—Ways and Means Committee, 70th Congress, 1st Session, House Report 2, 20.

158—House Discussion, Cong. Rec. Vol. 69, 653, Mr. Tilson: "The ability to pay must be governed by the net income of the entire group. Computing the income of each separate corporation is but the basing of an income tax upon paper profits. Our income tax law should be based as nearly as possible upon income actually realized."

159—Conference Committee, 70th Congress, 1st Session, House Report 1882, 16-17.

160—Senate Finance Committee, 70th Congress, 1st Session, Senate Report 960, 1, 13-15, 29.

161—*Ibid.*

162—*Ibid.*

163—*Ibid.*

164—*Ibid.*

165—*Ibid.*

166—*Ibid.*

167—1932, Sec. 141; Reg. 77, Art. 711, 713.

168—Senate Finance Committee, 72d Congress, 1st Session, Senate Report 665, 9-10, 33.

169—House Discussion, Cong. Rec. Vol. 75, 7124-28.

170—1934, Sec. 141; Reg. 86, Art. 141-1.

171—House Discussion, Cong. Rec. Col. 78, 7831. Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 17.

172—1936, Sec. 141; Reg. 94, Art. 141-1. 1938, Sec. 141; Reg. 101, Art. 141-1.

173—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 16-17. Ways and Means Subcommittee, 73d Congress, 2d Session, House Report Dec. 4, 1933, 10.

174—1928, Sec. 45. 1938, Sec. 45.

175—Ways and Means Committee, 70th Congress, 1st Session, House Report 2, 16-17.

176—1936, Reg. 94, Art. 45-1.

177—Dividends are usually not considered expenses because of their contingent nature, since expenses are usually not considered contingent upon earnings. The validity of this attitude is doubtful because other expenses, such as commissions, are frequently contingent upon income.

NOTES—CHAPTER VII

1—See Chapter IV of this thesis, for income realization.

2—See Chapter VIII of this thesis, for the nature of deductions.

3—See Chapter III of this thesis, for the time for taking deductions.

4—1913, Sec. II, G(a).

5—1913, Sec. II, G(a). 1938, Sec. 13.

6—1913, Reg. 33, Art. 107. 1916-17, Reg. 33, Art. 88.

7—See Chapter VI of this thesis for a discussion of dividends.

8—See Chapter V of this thesis for a discussion of non-recurring items.

9—See Chapter IV of this thesis for a discussion of income realization.

10—1913, Sec. B. 1938, Sec. 22(a); Reg. 101, Art. 22(a)-1.

11—1918, Reg. 45 (1920 ed.), Art. 31.

12—See footnote 10 above.

13—1926, Reg. 69, Art. 31.

14—See footnote 10 above

15—1918, Reg. 45 (1920 ed), Art. 35. 1938, Reg. 101, Art. 22(a)-5.

16—See Chapter X of this thesis.

17—See Chapter V of this thesis.

18—1918, Reg. 45, Art. 546. 1938, Reg. 101, Art. 22(a)-20.

19—1926, Reg. 69, Art. 31. 1938, Reg. 101, Art. 22(a)-1.

20—1926, Reg. 69, Art. 31.

21—1913, Sec. (B). 1938, Sec. 22(a); Reg. 101, Art. 22(a)-1.

22—1926, Sec. 213(b)(1); Reg. 69, Art. 72. 1938, Sec. 22(b)(1); Reg. 101, Art. 22(b)(1)-1.

23—Certain rather extensive provisions about such securities have been omitted from this discussion as being too detailed for our purposes. Such is particularly true of provisions regarding Liberty Loan bonds and related subjects.

24—1917, Sec. 1200; Reg. 33, Art. 83, 84, 85. T.D. 1892, Nov. 6, 1913 (1913 Law). 1913, Sec. B. 1938, Sec. 22(b)(4); Reg. 101, Art. 22(b)(4)-4.

25—*Ibid.*

26—1921, Reg. 62 (1922 ed.), Art. 77.

27—1928, Reg. 74, Art. 87.

28—1934, Reg. 86, Art. 22(b)(4)-4.

29—1936, Reg. 94, Art. 22(b)(4)-4. 1938, Reg. 101, Art. 22(b)(4)-4.

30—To the same effect: T.D. 1892, Nov. 6, 1913 (1913 Law).

31—1916, Sec. 4; Reg. 33, Art. 83, 84, 85. 1938, Sec. 22(b)(4); Reg. 101, Art. 22(b)(4)-1.

32—House Discussion, Cong. Rec., Vol. 50, 1261-63 (1913).

33—Ways and Means Committee, 65th Congress, 2d Session, House Report 767, 9.

34—Senate Finance Committee, 65th Congress, 3d Session, Senate Report 617, 6.

35—McColloch v. Maryland, 4 Wheaton 316 (1819). Osborn v. U.S. Bank, 9 Wheaton 738 (1824). Weston v. Charleston, 2 Peters 449 (1829). Dobbins v. Commrs. of Erie County, 16 Peters 435 (1842). Bank of Commerce v. City of New York, 2 Black 620 (1862). Collector v. Day, 11 Wallace 113 (1870). U.S. v. B. & O. R.R. Co., 17 Wallace 322 (1872). Mercantile Bank v. New York, 121 U.S. 138 (1886). Pollock v. Farmers Loan and Trust Co., 157 U.S. 429 (1895). Cooley, *Cooley on Taxation*, I, 3rd Ed. (1903) 129. Evans v. Gore, 253 U.S. 245 (1920). Macallen Co. v. Mass., 279 U.S. 620 (1929). (State tax on interest on Federal bonds held not permissible.)

36—Seligman, *The Income Tax* (1921), 614, 627. Barr, *A Proposal for Certain Changes in the Federal Income Tax Law* (Thesis) 1924. Edward S. Corwin, *New Republic*, Jan. 31, 1923. Hughes (as Gov. of New York in 1910), *Independent*, Jan. 6, 1923. Joshua Crozier, *Bulletin of the National Tax Assn.*, March, 1923. Opinion of Justice Clark, U.S. v. Hoboken, 29 F 2d 932. Opinion of Justice Holmes, Panhandle Oil Co. v. Knox, 277 U.S. 218 (1928). Willcuts v. Bunn, 282 U.S. 216,

51 S. Ct. 125 (1930). Educational Films Co. v. Ward, 282 U.S. 379 (1930). (Income from patents and copyrights taxable.) *Harvard Law Review,* Vol. 44 (1931), 651. Pacific Co. v. Johnson, 285 U.S. 480 (1932). Fox Film Corp. v. Doyal, 286 U.S. 123 (1932). (Income from patents and copyrights taxable.) Hatton, Director of Divn. of Income Taxation of Kentucky, "Reciprocal Immunity of Federal and State Instrumentalities," *Tax Policy League Symposium,* 26.

37—McColloch v. Maryland, 4 Wheaton 316 (1819).

38—Bullock, *Congressional Digest,* Sept., 1923.

39—Panhandle Oil Co. v. Knox, 277 U.S. 218 (1928) (Dissenting opinion.)

40—Seligman, *The Income Tax* (1921), 614.

41—Willcutts v. Bunn, 282, U.S. 216, 51 S. Ct. 125 (1930). *Harvard Law Review,* Vol. 44 (1931), 651.

42—Hardy, *Tax Exempt Securities and the Surtax* (1926.)

43—Seligman, *The Income Tax* (1921). Barr, *A Proposal for Certain Changes in the Federal Income Tax Law* (Thesis), 1924. Hunter, *Outlines of Public Finance* (1926), 317. (Quoting Pres. Harding.) Jackson, Robt. H., *Economics of Revenue Act of 1935,* 199. Studenski, "A Tax Program for the Future," *Taxation and Public Policy* (1936). President Roosevelt's Message to Congress, Jan. 19, 1939. American Institute of Accountants Committee on Federal Taxation, "Federal Tax Revision Program," *Journal of Accountancy,* Nov., 1939, 313.

44—U.S. v. Hoboken, 29 F. 2d 932. Seligman, *The Income Tax* (1921), 627.

45—1918, Reg. 45 (1920 ed.), Art. 75. 1921, Reg. 62 (1922 ed.), Art. 75.

46—1924, Reg. 65, Art. 75. 1932, Reg. 77, Art. 85.

47—1934, Reg. 86, Art. 22(b)(4)-2.

48—1936, Reg. 94, Art. 22(b)(4)-2. 1938, Reg. 101, Art. 22(b)(4)-2.

49—1918, Reg. 45 (1920 ed.), Art. 77.

50—1921, Reg. 62 (1922 ed.), Art. 77. 1938, Reg. 101, Art. 22(b)(4)-4.

51—1918, Reg. 45 (1920 ed.), Art. 76. 1938, Reg. 101, Art. 22(b)(4)-3.

52—1916-17, Reg. 33, Art. 94.

53—1916-17, Reg. 33, Art. 113.

54—Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918). U.S. v. Ludey, 274 U.S. 295 (1927).

55—See Chapter V.

NOTES—CHAPTER VIII

1—Mason, *Principles of Public Utility Depreciation* (1937), 5.

2—See Chapter II of this study for opinions in addition to the following: Paton, "Distribution Costs and Inventory Values," *Accounting Review,* Sept., 1927, 253. May, "Accrual Accounting for Reserves in Tax Practices," *Journal of Accountancy,* Dec., 1925, 257. Littleton, "Suggestions for the Revision of the Tentative Statement of Accounting Principles," *Accounting Review,* March, 1939, 60. Montgomery, "Accounting and the Concept of Income," Lectures on Taxation (1932) 63.

3—1913, II, G(a). 1916, Sec. 10. 1917, Sec. 10.

4—1918, Sec. 230(a). 1938, Sec. 13.

5—Dohr, "Income Divorced from Reality," *Journal of Accountancy,* Dec., 1938, 365: "While the Supreme Court, therefore, has fully recognized parts of the fundamental propositions set forth above, it has also permitted Congress to levy income taxes without consideration of certain items which prudent and intelligent businessmen and accountants would recognize in the computation of income, or which they would be compelled to recognize in connection with such laws as the Securities Act of 1933

and the Securities-Exchange Act of 1934, or indeed such basic laws as the law of fraud." Also see: Thomas, R., "Federal Income Taxation," *Journal of Accountancy*, Jan., 1939, 20.

6—1913, Reg. 33, Art. 158.

7—1916-17, Reg. 33, Art. 196.

8—Chapter VII is devoted to gross income items; this chapter, Chapter V, Chapter IX, and Chapter X are concerned with allowable deductions.

9—1918, Sec, 212, Sec. 232; Reg. 45, Art. 531. 1938, Sec. 21.

10—Helvering v. Independent Life Insurance Co., 291 U.S. 371 (1934). Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

11—It must be remembered that this study is concerned with "net income," not "operating net income."

12—Paton, "Distribution Costs and Inventory Values," *Accounting Review*, Sept., 1927, 253.

13—Frequently these items are not deductible for Federal income tax purposes.

14—Littleton, "The Relation of Function to Principles," *Accounting Review*, Sept., 1938, 238.

15—*Ibid.*, 239.

16—I.T. 1901, C.B., June, 1924, 120. T. H. Mastin, 7 (1927) BTA 72, affd. 28 F. 2d 748. Fleming G. Railey, 36 (1937) BTA 543. And others.

17—See Chapter VI regarding consolidated returns.

18—1913, G(b). 1938, Sec. 23(a).

19—1913, B(b).

20—L.O. 1045, C.B., Dec., 1920, 133.

21—1913, Reg. 33, Art. 114. 1938, Reg. 101, Art. 23(a)-1.

22—1918, Reg. 45 (1920 ed.), Art. 101.

23—1913, Reg. 33, Art. 131. 1938, Reg. 101, Art. 23(a)-4.

24—1913, Reg. 33, Art. 131.

25—1916, Reg. 33, Art. 131. 1917, Reg. 33, Art. 131.

26—S. Auerbach, 2 (1925) BTA 67. Harbeson Lumber Co., 24 (1931) BTA 542. And others.

27—Connecticut Mutual Life Insurance Co. v. Eaton, 218 Fed. 206.

28—Mutual Benefit Life Insurance Co. v. Herold, 198 Fed. 199.

29—1924, Reg. 65, Art. 102. 1938, Reg. 101, Art. 23(a)-2.

30—1913, G(b). 1938, Sec. 23(a), Reg. 101, Art. 23(a)-1.

31—The amortization by the lessee of leaseholds and leasehold improvements is discussed in Chapter IX.

32—Denholm & McNay Co. v. Commr., 39 (1939) BTA 104.

33—1918, Reg. 45 (1920 ed.), Art. 109. 1938, Reg. 101, Art. 23(a)-10.

34—Social security taxes are discussed under the heading of "Taxes" elsewhere in this Chapter.

35—1913, Reg. 33, Art. 120.

36—1916, Reg. 33, Art. 136.

37—1917, Reg. 33, Art. 136.

38—1918, Reg. 45 (1920 ed.), Art. 108. 1938, Reg. 101, Art. 23(a)-9.

39—1918, Reg. 45 (1920 ed.), Art. 108.

40—See Chapter III.

41—See footnote 38 of this chapter.

42—*Ibid.*

43—1928, Sec. 166. 1936, Sec. 166.

44—1938, Sec. 165(a)-2.

45—Senate Finance Committee, 70th Congress, 1st Session, Senate Report 960, 21, 22.

46—1932, Sec. 23(q). 1938, Sec. 23(p).

47—1928, Reg. 74, Art. 271. 1938, Reg. 101, Art. 23(p)-1.

48—O.D. 110, C.B., 1919, 224. 7 (1927) BTA 413. 33 (1935-36) BTA 1136. 90 F. 2d 767. And others.

49—1921, Reg. 62 (1922 ed.), Art. 105. 1938, Reg. 101, Art. 23(a)-6.

50—Also see T.B.M. 44, C.B., 1919, 220.

51—Alabama Cooperate Co., 18 (1929-30) BTA 128. King & Smith Co., 18 (1929-30) BTA 966. Chas. J. Derbes, et al., 24 (1931) BTA 276. L. Schepp Co., 25 (1931-32) BTA 419.

52—In addition to the Articles cited in footnote 49 of this chapter, see the following regarding earlier Acts: 1913, Reg. 33, Art. 119. 1916, Reg. 33, Art. 138. 1917, Reg. 33, Art. 138.

53—Gustafson Mg. Co., 1 (1924-25) BTA 508. Acme Land & Fur. Co., 31 (1934-35) BTA 582. Twin City Tile & Marble Co. v. Commr., 32 F. 2d 229, aff. 6 BTA 1238. Hecht v. U.S., 54 F. 2d 968. Jacobs v. Anderson, CCA, 228 Fed. 205. Botany Worsted Mills v. U.S., 278 U.S. 282. And others.

54—See footnote 49 of this chapter.

55—See footnote 49 of this chapter.

56—1921, Reg. 62 (1922 ed.), Art. 106. 1938, Reg. 101, Art. 23(a)-7.

57—Senate Finance Committee, 72nd Congress, 1st Session, Senate Report 665, 14.

58—Conference Committee, 72nd Congress, 1st Session, House Report 1492, 11.

59—Ways and Means Subcommittee, 73rd Congress, 2nd Session, House Report, Dec. 4, 1933, 11: "It appears that, while some desirable purpose might be accomplished from the limitation mentioned, no gain in revenue could be expected. On the contrary, if lower officers' salaries were actually paid, a loss in revenue would result. This comes about because high salaries bear not only the normal tax but heavy surtaxes, while distributions in dividends would bear no normal tax and on account of the spread of the amount distributed among all the stockholders would bear less surtax in the aggregate."

60—1913, Reg. 33, Art. 117.

61—1932, Reg. 77, Art. 53, Art. 54, Art. 52. 1934, Reg. 86, Art. 22(a)-2, Art. 22(a)-4. 1938, Reg. 101, Art. 22(a)-2, Art. 22(a)-4.

62—1932, Reg. 77, Art. 53.

63—1932, Reg. 77, Art. 54.

64—1932, Reg. 77, Art. 52.

65—For a good discussion of the problem of placing a value on such stock, see: Kunkel, "The Valuation of Compensation Stock," *Journal of Accountancy*, July, 1939, 48.

66—1913, Reg. 33, Art. 120. 1938, Reg. 101, Art. 23(a)-8.

67—Alabama Coca Cola Bottling Co., 1 (1924-25) BTA 837. Thomas N. Perkins, et al. 33 (1935-36) BTA 93. And others. T.D. 2626, Dec. 11, 1917, *Journal of Accountancy*, Feb. 1918

68—F. J. Hughes, 1 (1924-25) BTA 944. G. L. Rickard, 12 (1928) BTA 836. Burroughs Bus. Mach. Co. v. Commr., 47 F. 2d 178, aff. 18 (1929-30) BTA 101. And others.

69—I.T. 2135, C.B., June, 1925, 32.

70—E. Schlossberg, 2 (1925) BTA 683; and others.

71—Victor J. McQuade, 4 (1926) BTA 837.

72—A.R.R. 3131, C.B., Dec., 1923, 32. Jessie B. Wadsworth, 1 (1924-25) BTA

1042. F. L. Bateman, 34 (1936) BTA 351; nonacq. June, 1936. And many others.

73—1918, Sec. 236(b); Reg. 45, Art. 591.

74—1921, Sec. 236(c); Reg. 62 (1922 ed.), Art. 591.

75—1918, Sec. 236(c); Reg. 45, Art. 591.

76—1921, Sec. 236(c); Reg. 62 (922 ed.), Art. 591. 1924, Sec. 236(b); Reg. 65, Art. 491. 1926, Sec. 236(b); Reg. 69, Art. 591.

77—1928, Sec. 26(b); Reg. 74, Art. 301.

78—1918, Sec. 236(a); Reg. 45, Art. 591. 1938, Sec. 26(a); Reg. 101, Art. 26-1.

79—Special provisions related to the excess profits tax on corporations are not considered in this discussion.

80—1918, Sec. 238(a)(b).

81—Ways and Means Committee, 65th Congress, 2d Session, House Report 767, 11.

82—1921, Sec. 238(a)(b)(c). 1938, Sec. 131(a)(b)(c)(d)(e).

83—1924, Sec. 238(c).

84—Ways and Means Subcommittee, 73d Congress, 2d Session, House Report, Dec. 4, 1933, 9-10.

85—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 15-16.

86—1918, Reg. 45 (1920 ed.), Art. 294.

87—1917, Sec. 1211. 1938, Sec. 24(a)(4); Reg. 101, Art. 24-3. Atlas Heating & Ventilating Co., 18 (1929-30) BTA 389.

88—See footnote 87 of this chapter.

89—1916-17, Reg. 33, Art. 236.

90—T. D. 3019, May 18, 1920.

91—Berizi Bros. Co., 16 (1929) BTA 1307.

92—Jefferson G. G. Co. v. Commr., 52 F. 2d 120, rev. 16 BTA 1135.

93—*Time Magazine*, January 16, 1939. Herman Goedal v. Commr., 39 (1939) BTA, Jan. 3, 1939.

94—Pan American Hide Co., 1 (1924-25) BTA 1249. Thompson Scenic Ry. Co., 2 (1925) BTA 664; 9 (1927-28) BTA 1203. R. C. Alston, 4 (1926) BTA 1159. Potts Run Coal Co., 19 (1930) BTA 1. Spring Canyon Coal Co. v. Commr., 43 F. 2d 78, aff. 13 BTA 189.

95—This point is discussed in Chapter III under the heading of "Reserves."

96—1913, Reg. 33, Art. 121. 1934, Reg. 86, Art. 23 (o)-2.

97—Old Mission P. C. Co., 25 (1931-32) BTA 305.

98—Climax Spinning Co., 9 (1927) BTA 970.

99—Filbey, "The Deductibility of Contributions as Business Expenses," *Accounting Review*, Sept., 1931, 197.

100—O. D. 607, C. B., Dec., 1920, 265.

101—2 (1925) BTA 901. 18 (1930) BTA 467. And many others.

102—4 (1926) BTA 687, 689.

103—14 (1928) (BTA) 529 (reversed by 41 P. 2d 314).

104—9 (1927-28) BTA 771 (reversed by 37 P. 2d 798, 801). 3 (1925) BTA 28.

105—2 (1925) BTA 901.

106—5 (1926) BTA 347. 21 (1930-31) BTA 1316.

107—4 (1926) BTA 180.

108—2 (1925) BTA 525.

109—12 (1928) BTA 889.

110—1 (1924-25) BTA 6. 7 (1924-27) BTA 380.

111—1 (1924-25) BTA 1246.

112—2 (1925) BTA 740. 5 (1926-27) BTA 309, 464. 7 (1927) BTA 413. 6 (1927) BTA 78.

113—6 (1927) BTA 1247.

114—14 (1928-29) BTA 793.

115—20 (1930) BTA 796.

116—1 (1925) BTA 6, 1246. 2 (1925) BTA 740, 1239. 5 (1926) BTA 309, 347, 464. 6 (1927) BTA 78, 1247. 7 (1927) BTA 380, 413. 9 (1927-28) BTA 1203. 10 (1928) BTA 1134. 11 (1928) BTA 520. 14 (1928-29) BTA 793, 878. 15 (1929) BTA 1265. 19 (1930) BTA 467. 20 (1930) BTA 80, 796, 1132. 21 (1930) BTA 916. 22 (1931) BTA 267, 949, 1407. And many others.

117—Hotel Patton Co., et al., 13 (1928) BTA.

118—Anniston City Land Co., 2 (1925) BTA 526.

119—Bell-Rogers & Zemurray Bros. Co., 4 (1926) BTA 687. Anniston Auto Co., 4 (1925) BTA 689.

120—Western Flaterite Roofing Co., 19 (1930) BTA 467.

121—1936, Reg. 94, Art. 23(q)-1. 1938, Reg. 101, Art. 23(q)-1.

122—Killian Co., 20 (1930) BTA 80.

123—American Rolling Mill Co., 14 (1928) BTA 529.

124—41 Fed. 2d 314.

125—1928, Sec. 23 (a).

126—1928, Reg. 74, Art. 262. 31 Op. Atty. Genl. 617, 1919 (1918 Act). Baldwin Locomotive v. McCoach, et al., 215 Fed. 967.

127—1935, Sec. 102(r).

128—Ways and Means Committee, 74th Congress, 1st Session, House Report 1681. (Minority report.)

129—Donations to employees and others, which do not partake of the nature of compensation, are gifts and are not deductible. T. D. 2090. 1916-17, Reg. 33, Art. 135.

130—1936, Sec. 23(q).

131—1938, Sec. 23(q).

132—1938, Sec. 23(a)(2).

133—Ways and Means Subcommittee, 75th Congress, 3d Session, House Report, Jan. 1, 1938, 48.

134—Ways and Means Committee, 75th Congress, 3d Session, House Report 1860, 17-18.

135—1938, Reg. 101, Art. 23(a)-13.

136—Stempf, "Significant Changes in Federal Income Taxation," *Journal of Accountancy*, July, 1938, 36.

137—1936, Reg. 94, Art. 23(q)-1. 1938, Reg. 101, Art. 23(q)-1.

138—Brushaber v. Union Pacific R.R. Co., 240 U.S. 1, Jan. 24, 1916 (1913 Act).

139—1913, G(b) (third).

140—1916, Sec. 12(a) Third. 1917, Sec. 1207.

141—Discussion in the House, Cong. Rec., Vol. 53, 10656, regarding Section 12 (a) of the 1916 Act: Mr. Sherley: "The only reason I have been able to find from anybody has been the suggestion that otherwise a corporation, by distributing its earnings in the form of interest on a debt to its stockholders, might avoid the payment of a tax, but the provision has resulted in endless confusion in the department, conflicting rulings, and more trouble than almost any other single paragraph in the income-tax law."

142—See Chapter VI of this book.

143—1913, G(b) (third). 1916, Sec.12(a) Third. 1917, sec. 1207, amending 1916, Sec. 12(a).

144—1918, Sec. 234(a)(2). 1938, Sec. 23(b).

145—1916-17, Reg. 33, Art. 180.

146—T. D. 2625, December 17, 1917. Higginbotham-Bailey-Logan Co., 8 (1927) BTA 568.

147—Tel-Electric Co., 1 (1924-25) 434. Raymond-Hadley Corp., 4 (1928) BTA 889. Miller & Vidor Lumber Co. v. Commr., 39 F. 2d 890. And others.

148—West Maryland Ry. Co. v. Commr., 33 F. 2d 695, reverses 12 BTA 889. Chicago, Rock Island & Pac. Ry. Co., 13 (1928) BTA 988. Chicago & North Western Ry. Co., 22 (1931) BTA 1407.

149—1917, Sec. 12(a).

150—See footnote 144 of this chapter.

151—See footnote 144 of this chapter.

152—1921, Sec. 234(a)(2). Conference Committee, 67th Congress, 1st Session, House Report 586, 23.

153—Senate Finance Committee, 65th Congress, 3d Session, Senate Report 617, 6-7.

154—1932, Sec. 23(b).

155—Senate Finance Committee, 73d Congress, 2d Session, Senate Report 558, 24.

156—Kester, *Accounting—Theory and Practice*, II (1920), 468-472. Finney, *Principles of Accounting*, I (1929), Ch. 28, 8. Newlove-Smith-White, *Intermediate Accounting* (1939), 408.

157—See Chapter VI of this study.

158—*Ibid.*

159—1916-17, Reg. 33, Art. 187, 185.

160—1918, Reg. 45 (1920 ed.), Art. 121. 1938, Reg. 101, Art. 23(b)-1.

161—1918, Reg. 45, Art. 564. 1938, Reg. 101, Art. 23(b)-1.

162—1913, Reg. 33, Art. 52; Sec. II G(b) (fourth).

163—1916-17, Reg. 33, Art. 191; Sec. 12(a) Fourth. 1938, Sec. 23(c); Reg. 101, Art. 23(c)-1.

164—1913, Reg. 33, Art. 153.

165—1918, Reg. 45 (1920 ed.), Art. 131. 1938, Reg. 101, Art. 23 (c)-1.

166—1918, Reg. 45 (1920 ed.), Art. 131. 1938, Reg. 101, Art. 23 (c)-1.

167—1918, Reg. 45 (1920 ed.), Art. 32. 1938, Reg. 101, Art. 23 (c)-2.

168—See footnote 166 of this chapter.

169—I. T. 3265, Contributions to Michigan Fund. I. T. 3268, Contributions to an individual pension fund. Mimeo. 4595, C. B., 1937-1, 63. Also see Pension section of this chapter.

170—Ruling of Bur. of Int. Rev., *Journal of Accountancy*, April, 1937, 252.

171—I. T. 2708, C. B., Dec., 1933, 40. I. T. 2783, C. B., June, 1934, 54.

172—1913, Sec. II G(b) (fourth). 1938, Sec. 23(c)(2); Reg. 101, Art. 23(c)-1.

173—T. D. 2135, Deductible if paid in cash.

174—1916-17, Reg. 33, Art. 191. 1938, Sec. 23 (c) (1); Reg. 101, Art. 23 (c)-1.

175—1936, Sec. 23(c)(1); Reg. 94, Art. 23(c)-1.

176—1938, Sec. 23(c)(1); Reg. 101, Art. 23(c)-1.

177—Senate Finance Committee, 74th Congress, 2d Session, Senate report 2156, 15.

178—Montgomery, *Auditing Theory and Practice*, II, 534. Siimpson, *Eco-*

nomics for the Accountant, 196. Paton, *Accounting Theory* (1922) 179, 181, 182, 184.

179—Senate Discussion, Cong. Rec., Vol. 55, 6326-27.

180—1909.

181—Senate Discussion, Cong. Rec., Vol. 55, 6317-18.

182—Notes of the Month, "S.E.C.," *Journal of Accountancy,* Feb., 1937, 96.

183—1913, Sec. II(B); Reg. 33, Art. 153. 1938, Sec. 23(c)(4); Reg. 101, Art. 23(c)-3.

184—Lee Wilson & Co., 25 (1931-32) BTA 840. Chapman & Dewey Lumber Co., et al., 25 (1931-32) BTA 1166.

185—1924, Reg. 65, Art. 131. 1926, Reg. 69, Art. 131.

186—The italics are those of the author.

187—1924, Reg. 65, Art. 131.

188—1926, Reg. 69, Art. 131. 1938, Reg. 101, Art. 23(c)-1.

189—1924, Reg. 65, Art. 135. 1926, Reg. 69, Art. 135.

190—1928, Sec. 23(d). 1938, Sec. 23(d).

191—1913, Sec. II G(b) (Fourth); Reg. 33, Art. 152, 153, 158. 1916, Sec. 12(a); Reg. 33, Art. 191. 1917, Sec. 12(a), (amended by Sec. 1201).

192—1918, Sec. 234(a)(3). 1938, Sec. 23(c); Reg. 101, Art. 23(c)-1.

193—Schuster & Co. v. Williams, 283 Fed. 115, 1930 (1922 Act).

194—Appeal of Guaranty Constr. Co., BTA, Oct. 3, 1925, *Journal of Accountancy,* January, 1926, 44. Kaufman & Co., Inc. v. Bowers, Coll., U.S. District Ct., N.Y., *Journal of Accountancy,* June, 1926, 365.

195—Carondelet Bldg. Co., Inc. v. Fontenot, U.S. Dist. Ct., La., August 21, 1939.

196—G.C.M. 6273, C.B., June, 1929, 168.

197—I.T. 3157, C.B., 1938-1.

198—John Hancock Mut. Life Ins. Co., 10 (1926) BTA 736. Crown Willamette Paper Co., 14 (1928-29) 133. Pictorial Review Co., 26 (1932) BTA 472. These apparently reverse earlier decisions: Russell Milling Co., 1 (1924-25) BTA 194. W. S. Young & Co., 2 (1925) BTA 1164.

199—I. T. 2633, C. B., Dec., 1932, 77. Grand Hotel Co., 31 (1934-35) BTA 890. Carl K. Lifson, Admr., 36 (1937) BTA 593, affd. 98 F. 2d 508. Walsh-McGuire Co. v. Commr., 97 F. 2d 983. And others.

200—For a good bibliography of Board of Tax Appeals decisions regarding capital expenditures, see: Barton & Browning, *Federal Income and State Tex Laws* (1933), 84.

201—May, "Improvement in Financial Accounts," *Journal of Accountancy,* May, 1937, 335: "If the accounting period were increased from the customary year to a decade, most of what is now treated as capital expenditure would become chargeable to income; while if the period were reduced to a day, much of what is now treated as current maintenance would become capital expenditure."

202—The spreading of such capital expenditures is discussed in Chapter IX, Amortization.

203—1913, B.

204—1916, Sec. 12(a). 1917, Sec. 12(a).

205—1918, Sec. 235, Sec. 215; Reg. 45, Art. 581. 1938, Sec. 24(a).

206—1913, Reg. 33, Art. 118. 1916, Reg. 33, Art. 132.

207—1917, Reg. 33, Art. 132.

208—This has been discussed elsewhere in this chapter.

209—1913, Reg. 33, Art. 131.

210—1918, Reg. 45, Art. 582. 1921, Reg. 62 (1922 ed.), Art. 582. 1924, Reg. 65, Art. 582.

211—Hatfield, *Accounting* (1927), 67. But see: Chambers, "The Practicable Application of Tax Principles," *New York Society of Certified Public Accountants' Bulletin*, Jan., 1937, 38.

212—T. D. 2499, June, 1917, *Journal of Accountancy*, Aug., 1917, 120. See Chapter IX of this book for court decisions supporting T.D. 2499, and for a discussion of amortization of organization expenses.

213—Many cases may be cited which allow or disallow such items as expenses, but they are merely decisions of fact, not of principle.

214—A.R.R. 284, C.B., Dec., 1920, 208. A.R.R. 701, C.B., Dec., 1921, 176. I.T. 1382, C.B., Dec., 1922, 146. I.T. 1669, C.B., Dec., 1923, 122. S.M. 2423, C.B., Dec., 1924, 157. S.R. 6135, C.B., Dec., 1925, 152. West End Consolidated Mining Co., 3 (1925-26) BTA 128. Sunburst Oil & Refining Co., 23 (1931) BTA 829. And others.

215—The Beaumont Co., 3 (1925-26) BTA 822. Claude Neon Lights, Inc., 35 (1936-37) BTA 424. Hazeltine Corp., v. Commr., 89 F. 2d 513, reversing 32 BTA 110. And others.

216—Homer L. Strong, 14 (1928-29) BTA 902.

217—Goodell-Pratt Co., 3 (1925-26) BTA 30.

218—4 (1926) BTA 481. A.R.R. 98, C.B., II, 105.

219—Little Cahaba Coal Co. and Blockton Cahaba Coal Co. v. U.S., *Journal of Accountancy*, Jan., 1927, 44. O. D. 314, C.B., 1919, 143. G. R. Cotton, 25 (1931-32) BTA 866.

220—Sterling Oil & Gas Co. v. Lucas, 51 F. 2d 413.

221—Perkins Bros. Co. v. Commr., 78 F. 2d 152. Public Opinion Pub. Co. v. Jensen, 76 F. 2d 494. Meredith Pub. Co., v. Commr., 64 F. 2d 890. Public Opinion Pub. Co., 6 (1927) BTA 1255. Reuben H. Donnelley Corp., 26 (1932) BTA 107.

222—G.C.M. 15430, C.B., Dec., 1935, 49. Also see: M. P. Hutton v. Commr., 12 (1928) BTA 265. Mrs. E. A. Giffin, 19 (1930) BTA 1243. I. N. Burman, 23 (1931) BTA 639.

223—I. T. 3026, C.B., Dec., 1936, 83.

224—MacAdam & Foster, Inc., 8 (1927) BTA 967. Parkersburg Iron & Steel Co., 17 (1929) BTA 74; affd. 48 F. 2d 163. A. Sprunt & Co., Inc., 24 (1931) BTA 599. Julia Dahl et al., Executors, 24 (1931) BTA 1167.

225—Northern Michigan Transportation Co., 3 (1925-26) BTA 255.

226—Contadrink Filter Co., Inc., 6 (1927) BTA 667.

227—O.D. 1082, C.B., Dec., 1921, 75.

228—1916-17, Reg. 33, Art. 156.

229—Green, E. H., "Some Aspects of the Problem of Income Taxation from the Standpoint of Corporations," *Lectures on Taxation*, 1932.

230—McEwen Lumber Co., 1 (1924-25) BTA 73. Robert Buedingen, 6 (1927) BTA 335.

231—Hatfield, *Accounting* (1927), 82. Finney, *Principles of Accounting*, II (1930), Ch. 38, p. 10. Newlove-Smith-White, *Intermediate Accounting* (1939), 221

232—1932, Sec. 113(b)(1).

233—I. T. 2664, C.B., Dec. 1932, 43.

234—I. T. 2284, C.B., June, 1926, 10.

235—H. Citrin, 2 (1925) BTA 626. See Chapter IX, Amortization.

236—1918, Reg. 45, Art. 582. 1926, Reg. 69, Art. 582.

237—1918, Reg. 45, Art. 293. 1938, Reg. 101, Art. 24-2.

238—I. T. 1688, C.B., June, 1923, 116.

239—Killian Co., 20 (1930) BTA 80. S. C. Toof & Co., 21 (1930-31) BTA 916.

240—Mrs. Wm. P. Kyne, et al., 35 (1936-37) BTA 202. Old Mission Portland Cement Co. v. Commr., 69 F. 2d 676; affing. 25 BTA 305. Sunset Scavenger Co., Inc. v. Commr., 84 F. 2d 453, reversing 31 BTA 658.

241—David A. Reed, 13 (1928) BTA 512.

242—T.D. 2137. 1916-17, Reg. 33, Art. 143.

243—Columbus Bread Co., 4 (1926) BTA 1126. Burroughs Bldg. Material Co., 18 (1929-30) BTA 101, affd. 47 F. 2d 178. Great Northern Ry. Co. v. Commr., 40 F. 2d 372, affing. 8 BTA 225. S.R. 1488, C.B., June, 1925, 140. I.T. 1174, C.B., June, 1922, 269.

244—G.C.M. 11358, C.B., June, 1933, 29 (overruled Sol. Law Op. 926, C.B. 1919, 241.).

245—Burroughs Bldg. Material Co. v. Commr., 47 F. 2d 178. Peoples-Pittsburgh Trust Co., et al., 21 (1930-31) BTA 588. O.D. 952, June, 1921. I.T. 2303, Dec., 1925. Many other court and Board of Tax Appeals decisions.

246—1934, Sec. 24(a)(5); Reg. 66, Art. 24-4. 1938, Sec. 24(a)(5); Reg. 101, Art. 24-4.

247—Ways and Means Committee, 73d Congress, 2d Session, House Report 704, 23.

248—Senate Finance Committee, 73d Congress, 2d Session, Senate Report 558, 26-27.

249—See footnote 144 of this chapter.

250—Victor G. Marquissee, Walter R. Lewis, et al., 11 (1928) BTA 334. Affirmed by Lewis v. Commr., 47 F. 2d 32.

251—G.C.M. 9954, C.B., Dec., 1931, 253.

252—G.C.M. 10123, C.B., Dec., 1931, 254.

253—John H. Watson, Jr., et al., 35 (1936-37) BTA 760.

254—1937, Sec. 301.

255—Joint Committee on Tax Evasion and Avoidance, Report, Aug. 5, 1937, 15, 16.

256—1938, Sec. 24(c); Reg. 101, Art. 24-6.

257—1916-17, Reg. 33, Art. 185.

258—See Chapter VI of this book.

NOTES–CHAPTER IX

1—The amortization of bond discounts and premiums is different in nature, however.

2—U.S. v. Kansas Pacific Railway Co., 99 U.S. 459 (1878). Eyster v. Centennial Board of Finance, 94 U.S. 500, 503 (1876).

3—Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909). R. R. Comm. v. Cumberland Tel. & Tel. Co., 212 U.S. 414 (1909). Lincoln Gas & Electric Light Co. v. Lincoln, 223 U.S. 349 (1912). Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U.S. 544 (1912). Galveston Electric Co. v. Galveston, 258 U.S. 388 (1922). United Railways & Electric Co. v. West, 280 U.S. 234 (1930). Clark's Ferry Bridge Co. v. Pub. Serv. Comm., 291 U.S. 227 (1934). Also see: 1913, Reg. 33, Art. 133. 1916-17, Reg. 33, Art. 161, 164.

4—Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909). Lincoln Gas & Electric Light Co. v. Lincoln, 223 U.S. 349 (1912). Denver v. Denver Union Water Co., 246 U.S. 718 (1918). Lindheimer v. Illinois Bell Tel. Co., 292 U.S. 151 (1934).

5—Kester, *Accounting Theory and Practice,* II (1920), 126, 141. Mason, *Principles of Public Utility Depreciation* (1937), 5. Grady, "Principles of Depreciation," *Papers on Accounting Principles and Procedure—1938,* 15. Finney, *Principles of Accounting,* II (1930) Ch. 40, 4.

6—Smails, "Some Aspects of Depreciation," *Accounting Review,* June, 1927, 105.

7—Wilmot, "Depreciation," *Journal of Accountancy,* December, 1909, 104.

8—Scott, "Valuation for Depreciation and the Financing of Replacements," *Accounting Review,* December, 1929, 221.

9—1918, Reg. 45, Art. 165. 1938, Reg. 101, Art. 23(1)-5. *Depreciation Studies of the Bureau of Internal Revenue* (1928).

10—Theodore Tiedemann & Sons, Inc., 1 (1924-25) BTA 1077.

11—Otis Steel Co., 6 (1927) BTA 358.

12—The Cumberland Glass Mfg. Co. v. U.S., 71 Ct. Cl. 44. Albia Box and Paper Co., 4 (1926) BTA 1184. Northeastern Oil & Gas Co., 5 (1926-27) BTA 332. Otis Steel Co., 6 (1927) BTA 358.

13—I.T. 2369, C.B., December, 1927, 63.

14—N. H. Brady, 7 (1927) BTA 818. Rainbow Gasoline Corp., 32 (1935) BTA 1050. And many others.

15—Hatfield, *Accounting* (1927) 157, 160. Finney, *Principles of Accounting* II (1930) Ch. 39, 5. Saliers, "Depreciation in Financial Statements," *Journal of Accountancy,* March, 1937, 188. May, "Improvement in Financial Accounts," *Journal of Accountancy,* May, 1937, 352. Mason, *Principles of Public Utility Depreciation* (1937) 9, 14. Grady, "Principles of Depreciation," *Papers on Accounting Principles and Procedure—1938,* 15.

16—Kester, *Accounting Theory and Practice* II (1920) 139. Hatfield, *op. cit.* Castenholz, "The Accountant and Changing Monetary Values," *Accounting Review,* December, 1931, 284. American Institute of Accountants, *Accounting Questions and Answers* (1937), Ans. 32, 103, August, 1935. Saliers, *op. cit.,* 188. Mason, *op. cit.,* 14.

17—See pages 186-188.

18—See pages 188-189.

19—Scott, "The Tentative Statement of Principles," *Accounting.*

20—1913, Reg. 33, Art. 129, 130. 1938, Reg. 101, Art. 23(1)-1, 4.

21—U.S. v. Ludey, 274 U.S. 295. Inecto v. Commr., 50 F. 2d 1078 (aff. 20 BTA 566). Consolidated Coke Co. v. Commr., 70 F. 2d 446 (aff. 25 BTA 345). Frost Mfg. Co., 13 (1928) BTA 802. O. O. Owens, 26 (1932) BTA 1147.

22—1924, Sec. 204(c). 1938, Sec. 114(a), 23(n).

23—Castenholz, "The Accountant and Changing Monetary Values," *Accounting Review,* December, 1931, 287.

24—1913, Reg. 33, Art. 146. O.D. 283, C.B., 1919, 138. Fr. Bergnor & Co., 4 (1926) BTA 460. National Packing Corp., 24 (1931) BTA 952. Finney, *Principles of Accounting,* II (1930) Ch. 40, 4. Grady, "Principles of Depreciation," *Papers on Accounting Principles and Procedure—1938,* 15.

25—Sweeney, "Stabilized Depreciation," *Accounting Review,* Sept., 1931, 165.

26—See page 188.

27—Harmony Grove Mills, 2 (1925) BTA 1200. Blair Veneer Co., 3 (1926-27)

BTA 886. Champion C. P. Co., 10 (1928) BTA 433. Camden Woollen Co., 12 (1928) BTA 1277. Hyatt R. B. Co. v. U.S., 70 Ct.Cl. 443. Newlove-Smith-White, *op. cit.*, 263.

28—However, this is not true of depletion. See pages 194-197 of this book.

29—1916-17, Reg. 33, Art. 162. 1938, Reg. 101, Art. 23(l)-1, 5.

30—1916-17, Reg. 33, Art. 162. But see: 1913, Reg. 33, Art. 129.

31—Rock Spring Dist. Co., 2 (1925) BTA 207. Oglesby Coal Co. v. Commr., 46 F. 2d 617 (aff. 18 BTA 1245).

32—1918, Sec. 234(a)-7; Reg. 45, Art. 161, 166. 1938, Sec. 23(l); Reg. 101, Art. 23(l)-1, 6.

33—1918, Sec. 234(a)-8; Reg. 45, Art. 181-188. 1921, Sec. 234(a)-8; Reg. 62, Art. 181-188.

34—Burnett v. Niagara Falls Brewing Co. et al., 282 U.S. 648.

35—*Ibid.* Columbia Malting Co., 1 (1924-25) BTA 999. Gulf Coast I. Co., 24 (1931) BTA 958. Lassen L. & B. Co. v. Blair, 27 F. 2d 17 (aff. 6 BTA 241). And others.

36—O.D. 381, C.B., June, 1920, 138. G.C.M. 1905, C.B. Dec., 1927, 210.

37—1928, Reg. 74, Art. 203. 1932, Reg. 77, Art. 203. 1938, Reg. 101, Art. 23(1)-3.

38—Only a very few of a great host of such decisions are cited: Clark v. Haberle Crystal Sp. Br. Co., 280 U.S. 384; rev. 30 F. 2d 219; aff. 20 F. 2d 540. Red Wing Malting Co. v. Willcuts, 15 F. 2d 626, aff. 8 F. 2d 180. Secor Hotel Co., 7 (1927) BTA 158. San Francisco Hotel Co., 19 (1930) BTA 383.

39—Hupfel Co., Inc. v. Anderson, 51 F. 2d 115.

40—C.B., Dec., 1927, 63. (T.D. 4055 dated Aug. 5, 1927.)

41—15 F. 2d 626.

42—Simpson v. Shepard, 230 U.S. 352 (1913). Kansas City Southern Ry. Co. v. U.S., 231 U.S. 423 (1913). Denver v. Denver Union Water Co., 246 U.S. 178 1918. Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151 (1934).

43—The Southern Amusement Co. Inc., Memo. BTA, March 23, 1939.

44—American Institute of Accountants, Report of the Committee on Terminology; Hatfield, *Accounting* (1927) 131.

45—Moyer, "Economic Aspects of Fixed Capital Obsolescence," *Accounting Review*, September, 1939, 287.

46—Paton, "Economic Theory in Relation to Accounting Valuations," *Accounting Review*, June, 1931, 91, 92. Castenholz, "Investing in Obsolescence," *Accounting Review*, September, 1928, 272. C.B. II, 1922, 161.

47—Bulletin "F," January, 1931, 12. Gould-Mersereau Co., 21 (1930-31) BTA 1316. Graves, Cox & Co., 27 (1932-33) BTA 546.

48—1913, Reg. 33, Art. 140. 1938, Reg. 101, Art. 23(1)-4, 5.

49—1916-17, Reg. 33, Art. 175, 179. 1938, Reg. 101, Art. 23(1)-8.

50—G.C.M. 13148.

51—Campbell Products, Inc., BTA memo. July 27, 1939.

52—F. M. Hubbels & Son, Inc. v. Burnet, 51 F. 2d 644 (affing. 19 BTA 612).

53—G.C.M. 5589, C.B., June, 1929, 83 (revoked by G.C.M. 9461, C.B., June, 1931, 120. Clinton Mills, Inc. v. Commr., 78 F. 2d 292 (Rev. 28 BTA 1312).

54—1913, Reg. 33, Art. 115. 1938, Reg. 101, Art. 23(a)-10.

55—W. W. Carter Co., 1 (1924-25) BTA 849 (nonacq., C.B., Dec., 1930, 70).

56—Finney, *Principles of Accounting*, II (1930) Ch. 42, 3. T.D. 3414, October 25, 1922 (applied to 1916, 1917, 1918, and 1921 acts). O.D. 1013, C.B., Dec.,

1921, 130. T.D. 3760, C.B., June, 1925, 154 (amending T.D. 3414, C.B., Dec., 1922, 90). Grosvenor Atterbury, 1 (1924-25) BTA. Automatic Exposition Co., 11 (1928) BTA 1397. Henrici v. Reinecke, 3 F. 2d 774. Kaufman-Straus Co. v. Lucas, 12 F. 2d 774. And others. Contra: Wyoming National Bank, 23 (1931) BTA 408.

57—Simmons & Hammond Mfg. Co., 1 (1924-25) BTA 803. I. G. Zumwalt, 25 (1931-32) BTA 566. Duffy v. Central Railway of N.J., 268 U.S. 55. National City Bank of Seattle v. U.S. 64 Ct.Cl. 236. O.D. 516, C.B., June, 1920, 112. S.R. 1236, C.B., Dec., 1924, 161.

58—I.T. 1711, C.B., Dec., 1923, 104. A.R.R. 6459, C.B., June, 1924, 138. 353 Lexington Ave. Corp., 27 (1932-33) BTA 762 (nonacq. C.B., June, 1933, 23). 1620 Broadway Corp., 36 (1937) BTA 149. Bonwit Teller & Co. v. Commr., 53 F. 2d 381. 379 Madison Ave., Inc. v. Commr., 60 F. 2d 68 (reversing 23 BTA 29). Varick Holding Corp. v. Bowers, 73 F. 2d 1020. Contra: Pittsburgh Union Stock Yards Co., 16 (1929) BTA 139.

59—Thatcher Medicine Co., 3 (1925-26) BTA 154. The Geo. C. Bowman Co., 7 (1927) BTA 399 (affd. 32 F. 2d 404). Simons Brick Co., 14 (1928-29) BTA 878 (affd. 45 F. 2d).

60—Finney, *Principles of Accounting,* II (1930) Ch. 38, 12. Newlove-Smith-White, *op. cit.,* 250.

61—I.T. 1171, C.B., June, 1922, 117 (revoked by I.T. 2263). Robt. H. McNeill, 16 (1929) BTA 479 (reversed 2 BTA 1056; nonacq., C.B., Dec., 1929, 67).

62—I.T. 2263, C.B., June, 1926, 66 (revoked I.T. 1171). Julia Stow Lovejoy, 18 (1929-30) BTA 1179. Bonwit Teller & Co., v. Commr., 53 F. 2d 381. And others.

63—1913, Reg. 33, Art. 174. 1938, Reg. 101, Art. 23(1)-3.

64—Sterling Oil & Gas Co. v. Lucas, 51 F. 2d 413.

65—Hatfield, *Accounting* (1927) 128, 129, 147, 148. "Accounting Questions," *Journal of Accountancy,* Aug. 1939, 122.

66—1913, Reg. 33, Art. 137, 138, 174. 1938, Reg. 101, Art. 23(1)-7.

67—Union Metal Mfg. Co., 1 (1924-25) BTA 395. Letter from the Office of the Commissioner of Internal Revenue, September 24, 1915, "Income Tax Department," *Journal of Accountancy,* November, 1915, 384. Kester, *Accounting Theory and Practice,* II (1920) 319, 325, 326. Toulmin, "Patents in the Income Tax Return," *Journal of Accountancy,* September, 1925, 183. Finney, *Principles of Accounting,* II (1930) Ch. 42, 1, 2.

68—Finney, *op. cit.,* Ch. 42, 3.

69—*Ibid.* 1916-17, Reg. 33, Art. 168.

70—See Preinreich, "Goodwill in Accounting," *Journal of Accountancy,* July, 1937, 28, for a good discussion of goodwill.

71—Niven, "Income Tax Department," *Journal of Accountancy,* Aug., 1917, 120. Kester, *op. cit.,* 330-1. Paton, "Economic Theory in Relation to Accounting Valuations," *Accounting Review,* June, 1931, 90. LaSalle Extension University, *Manual of Federal Income Tax Procedure* (1939) 184.

72—Hatfield, *op. cit.,* 124.

73—Kester, *op. cit.,* 338. *Ibid.,* I (1930) 540. Finney, *op. cit.,* Ch. 42, 1, 2; Ch. 38, 2.

74—Littleton, "Suggestions for the Revision of the Tentative Statement of Accounting Principles," *Accounting Review,* March, 1939, 59.

75—See page 190.

76—T. D. 2499, June 11, 1917. 2 BTA 647, 3 BTA 807, 7 BTA 662, 11 BTA

503, 14 BTA 793, 15 BTA 1014, 19 BTA 490, 23 BTA 308, 26 BTA 1192, 29 BTA 368, 32 BTA 339, 34 BTA 1191, 33 F. 2d 75, 74 F. 2d 1015, 90 F. 2d 43.

77—1913, Reg. 33, Art. 136. 1916-17, Reg. 33, Art. 167, 168. Red Wing Malting Co. v. Willcuts, C.C.A., *Journal of Accountancy*, January, 1927, 43.

78—Bulletin "F," revised Jan., 1931, 18. A.R.R. 399, C.B., Dec., 1920, 169. Norwich Pharmacal Co., 30 (1934) BTA 326. E. C. McKallor Drug Co., 1 (1924-25) BTA 1017. Paul Jones & Co. v. Lucas, 15 Am. Fed. Tax. Rep. 681 (affd. 64 F. 2d 1016).

79—Mason, *Principles of Public Utility Depreciation* (1937) 15. The Independent Brick Co. of Iowa, 11 (1928) BTA 862 (nonacq. C.B., June, 1929, 55). Kettridge v. Commr., 88, F. 2d 632.

80—1913, Sec. G(b); Reg. 33, Art. 130. 1938, Sec. 23(1); Reg. 101, Art. 23(1)-1.

81—1918, Reg. 45, Art. 162. 1938, Reg. 101, Art. 23(1)-2. P. Dietz, 7 (1927) BTA 1048. Munising Motor Co., 1 (1924-25) BTA 286.

82—A. P. Adams, 1 (1924-25) BTA 983. New Orleans T. & M. Railway Co., 6 (1927) BTA 436. Old Mission P. C. Co., 25 (1931-32) 305.

83—Union Terminal Cold Storage Co., 4 (1926) BTA 264. But see: Nashville, Chattanooga & St. Louis R.R. Co. v. U.S., 269 Fed. 351. 1916-17, Reg. 33, Art. 162. 1938, Reg. 101, Art. 23(1)-2. But see: 1913, Reg. 33, Art. 129.

84—San Francisco, etc. Co., v. Scott, 253 F. 854. Hatfield, *Accounting* (1927) 160.

85—W. Ziegler, 1 (1924-25) BTA 186. Roshek Bros. Co. 2 (1925) BTA 260, 794. Union Terminal Cold Storage Co. 4 (1926) BTA 264. Mason, *Principles of Public Utility Depreciation* (1937) 4.

86—Farmers Grain Co., 1 (1924-25) BTA 605. Wm. Ferguson, 23 (1931) BTA 364. Mitchell v. Commr., 48 F. 2d 697 (aff. BTA 994). And others.

87—O.D. 845, June, 1921, 178. Bulletin "F," revised January, 1931, 17.

88—St. Louis Malleable Castings Co., 9 (1927-28) BTA 110.

89—Perhaps, with the exception of certain financial items.

90—Atlantic Carton Co. (1925), BTA 380.

91—Western V. B. Co. 3 (1925-26) BTA 749. Symington Anderson Co. v. Commr., 33 F. 2d 372.

92—No attempt is made in this chapter to discuss the detailed methods and intricacies of depletion computations.

93—1913, Sec. G(b); Reg. 33, Art. 141, 142, 139. 1938, Sec. 23(m); Reg. 101, Art. 23(m)-1-28 incl.

94—See page 195.

95—1918, Reg. 45, Art. 208. 1938, Reg. 101, Art. 23(m)-8.

96—1918, Reg. 45, Art. 222, 223. 1938, Reg. 101, Art. 23(m)-15, 16.

97—The five per cent limitation was upheld in Stanton v. Baltic Mining Co., et al., 240 U.S. 103 (1916). In fact, it was held in Von Baumbaugh v. Sargent Land Co., 242 U.S. 503, that income could be taxed without allowing any depletion deduction.

98—Prior to 1918, only the original capital might be recovered in total.

99—Senate Discussion, Cong. Rec. Vol. 67, 3018-19, 3766-67, 3878.

100—Ways and Means Committee, 73d Congress, 2d Session, House Report 29, 704.

101—Senate Discussion, Cong. Record, Vol. 78, 6181.

102—McKellar, Senate Discussion, Congressional Record, Vol. 78, 6177-78. This discussion took place in connection with an attempt made to eliminate discovery and percentage depletion.

103—Phoenix Oil P. Co., 25 (1931-32) BTA 1239 (1926 Act).

104—Reed, Senate Discussion, Congressional Record, Vol. 67, 3018-19, 3766-67, 3878.

105—Editorial, *Journal of Accountancy,* October, 1937, 246.

106—Fernald-Peloubet-Norton, "Accounting for Nonferrous Metal Mining Properties and their Depletion," *Journal of Accountancy,* August, 1939, 114.

107—*Ibid.*

108—Barr, *A Proposal for Certain Changes in the Federal Income Tax Law,* 1924. Andruss, "Accounting for the Depletion of Oil Lands," *Journal of Accountancy,* August, 1936, 116. "Correspondence Section," *Journal of Accountancy,* January, 1938, 61.

109—For a detailed defense of percentage and discovery depletion, see Fernald, "Correspondence Section," *Journal of Accountancy,* February, 1938, 150.

110—1913, Reg. 33, Art. 135. 1938, Reg. 101, Art. 22(a)-16.

111—Chicago, R. I. & Pac. Railway Co., 13 (1928) BTA 988. Colorado & Southern Ry. Co., 36 (1937) BTA 1248. S.M. 3691, C.B., June, 1925, 145. G.C.M. 14349, C.B., June, 1935, 47. West Maryland Ry. Co. v. Commr., 33 F. 2d 695 (rev. 12 BTA 889). Lincoln Mtg. & Title Guaranty Co. v. Commr., 79 F. 2d 585. Helvering v. Union Pacific R.R. Co., 293 U.S. 282 (rev. 69 F. 2d 67). Contra: So. Pacific R.R. Co. v. Muenter, 260 F. 837 (1909 Act). Old Colony Ry. Co., 6 (1927) BTA 1025. Conn. & Pass. Rivers R.R. Co., 8 (1927) BTA 492. Missouri Pacific Railway Co., 22 (1931) BTA 267.

112—Kester, *Accounting Theory and Practice,* II (1920) 269, 474. *Ibid.,* I (1930) 376. Hatfield, Accounting (1927) 89-95, 229. Finney, *Principles of Accounting,* II (1930) Ch. 44. American Institute of Accountants, *Accounting Questions and Answers* (1937) 40 (March, 1926). Staub, "Uniformity in Accounting," *Papers on Accounting Principles and Procedure—1938,* 4, 5. Newlove-Smith-White, *Intermediate Accounting* (1939) 205.

113—1918, Reg. 45, Art. 544, 563, 848. O.D. 475, C.B., June, 1920, 211. S.M. 3820, C.B., December, 1925, 25.

114—T. D. 3872, May 21, 1926.

115—For amortization: Chicago Acceptance Co., 12 (1928) BTA 150, 152. Vancob Realty Co., 33 (1935-36) BTA 918 (nonacq., C.B., December, 1936, 49). New York Life Insurance Co. v. Edwards, 3 F. 2d 280 (1913 Act) (reversed by 8 F. 2d 851 and 271 U.S. 109). Against amortization: New York Life Insurance Co. v. Edwards, 8 F. 2d 851, 271 U.S. 109. Corn Exchange Bank, 6 (1927) BTA 158 (1921 Act).

116—See Chapter V for further discussion of this subject.

117—Hatfield, *Accounting* (1927) 169. May, "Improvement in Financial Accounts," *Journal of Accountancy,* May, 1937, 354.

118—Kester, *Accounting Theory and Practice,* II (1920) 126.

119—See Chapter V of this thesis.

120—Stockwell, "Depreciation, Renewal, and Replacement Accounts," *Journal of Accountancy,* December, 1909, 89. Saliers, "Depreciation Reserves versus Depreciation Funds," *Journal of Accountancy,* November, 1913, 365. Kester, *Accounting Theory and Practice,* II (1920) 103. Hatfield, *Accounting* (1927) 135, 137.

121—Hatfield, *op. cit.,* 136, 140. Saliers, "Inadequate Depreciation Methods," *Accounting Review,* September, 1937, 303. Kaplan & Reaugh, "Accounting, Reports to Stockholders, and the SEC," *Accounting Review,* September, 1939, 27.

122—Keene, "Invested Capital," *Journal of Accountancy,* Feb., 1921, 111.

123—1913, Reg. 33, Art. 130. 1926, Reg. 69, Art. 169.

124—1916-17, Reg. 33, Art. 165. 1932, Reg. 77, Art. 205. Also see T.D. 3061, Aug. 27, 1920.

125—1934, Reg. 86, Art. 23(1)-5. 1936, Reg. 94, Art. 23(1)-5. 1938, Reg. 101, Art. 23(1)-5.

126—Newlove-Smith-White, *op. cit.*, 275.

127—O.D. 948, C.B., June, 1921, 180. Fort Orange Paper Co., 1 (1924-25) BTA 1230. Motor Car Supply Co., 9 (1927-28) BTA 556.

128—Land Imp. & Supply Co., 18 (1929-30) BTA 963 (nonacq., C.B., December, 1930, 77. But see page 191.

129—A.R.R. 3515, C.B., December, 1923, 91.

130—47 S.Ct. 608 (reversing 61 Ct.Cl. 126). Rieck v. Heiner, 25 F. 2d 453 (affing. T.D. 4087). U.S. v. Ludey, 274 U.S. 295. Even Realty Co., 1 (1924-25) BTA 355. Pittsburgh Brewing Co., 37 (1938) BTA 439. And others.

131—1921, Reg. 62, Art. 165. 1932, Reg. 77, Art. 205.

132—1934, Reg. 86, Art. 23(1)-5. 1936, Reg. 94, Art. 23(1)-5. 1938, Reg. 101, Art. 23(1)-5.

133—I.T. 2838, C.B., Dec., 1934, 133 (explanation of T.D. 4422). Magill, address given before a women's club in 1934.

134—I.T. 2838.

135—Mimeo. 4170, C.B., XIII-1, 59 (interpretation of T.D. 4422).

136—Peloubet, "Special Problems in Accounting for Capital Assets," *Journal of Accountancy*, March, 1936, 185.

137—Saliers, "Inadequate Depreciation Methods," *Accounting Review*, September, 1937, 304.

138—If other than cost is chosen as the basis under a binding option, as in the case of coal, metal, or sulphur mines, cost may not necessarily be recovered.

NOTES–CHAPTER X

1—Haig, *The Federal Income Tax* (1921) 18.

2—1913, Reg. 33, Art. 123, 161. 1938, Reg. 101, Art. 23(a)-3.

3—1916, Sec. 13(d).

4—1918, Sec. 203. 1938, Sec. 22(c).

5—1921, Reg. 62, Art. 1582. 1938, Reg. 101, Art. 22(c)-2.

6—C. Willenborg & Co., 5 (1926-27) BTA 788. Neusteter Suit Co., 8 (1927) BTA 477.

7—1918, Reg. 45, Art. 1582. See footnote 5.

8—Thomas Shoe Co., 1 (1924-25) BTA 124. The Reuben H. Donnelly Corp., 22 (1931) BTA 175. And many others.

9—Bunce Co. v. Eaton, 36 F. 2d 379. Chicago Frog & Switch Co. v. U.S., 68 Ct.Cl. 186.

10—May, "Improvement in Financial Accounts," *Journal of Accountancy*, May, 1937, 353. Testimony of Expert Witnesses at S.E.C. Hearings, "Accounts' Responsibility for Inventories," *Journal of Accountancy*, May, 1939, 282.

11—Willenborg & Co., 5 (1926-27) BTA 788.

12—Ozark Mills, Inc., 6 (1927) BTA 1179.

13—1913, Reg. 33, Art. 161. See footnote 5.

14—1918, Reg. 45, Art. 581. 1938, Reg. 101, Art. 22(c)-1.

15—Cleveland Woolen Mills, 8 (1927) BTA 49.

16—1916-17, Reg. 33, Art. 160, 169. See footnote 5.

17—Mackenzie, "The Verification of Inventories in Audits and Examinations of Manufacturing and Trading Concerns," *Journal of Accountancy*, December, 1909, 114. Kester, *Accounting Theory and Practice*, II (1920) 230.

18—Summit Wholesale Groc. Co., 1 (1924-25) BTA 1040. Mrs. C. J. Barnard, 18 (1929-30) BTA 1022. And others.

19—Lucker v. U.S., 72 Ct.Cl. 606, 53 F. 2d 418. Queen City Woodworks & Lumber Co. v. Crooks, 7 F. Supp. 684. Farmers Hardware Co. 2 (1925) BTA 90.

20—A. Reid & Co., 2 (1925) BTA 425.

21—1921, Reg. 62, Art. 1582. 1938, Reg. 101, Art. 22(c)-1.

22—Farmers Hardware Co., 2 (1925) BTA 90. A. Reaid & Co., 2 (1925) BTA 425.

23—C. E. Longley Co., 4 (1926) BTA 246. Steiner Tire Co., 9 (1927-28) BTA 1289.

24—Kleeman Dry Goods Co., 2 (1925) BTA 369. Burton Coal & Lumber Co., 22 (1931) BTA 133. The James H. Bunce Co. v. Eaton, 36 F. 2d 379. And others. But see: Fred S. Stewart Co., 5 (1926-27) BTA 436. May Lumber Co., 13 (1928) BTA 62. The Wickens Co., 16 (1929) BTA 968. Wood & Ewer Co. v. Ham, 14 F. 2d 995.

25—Haas Bros., 3 (1925-26) BTA 113. A. J. Keeney, 17 (1929) BTA 56. And many others.

26—See footnote 21.

27—1918, Reg. 45, Art. 1592. See footnote 5.

28—Geo. C. Peterson Co., 1 (1924-25) BTA 690. Rogers, Brown & Crocker Bros. Inc., 32 (1935) BTA 207.

29—Paton, "Valuation of Inventories," *Journal of Accountancy*, December, 1922, 434, 436. Kester, *Accounting Theory and Practice*, second ed., II, 153.

30—Newlove-Smith-White, *op. cit.*, 168.

31—1918, Reg. 45, Art. 1583. 1938, Reg. 101, Art. 22(c)-3.

32—Trorlicht-Duncker Carpet Co., 22 (1931) BTA 466 (Trade Discounts).

33—Riverside Mfg. Co. v. U.S., 67 Ct.Cl. 117. May, Stern & Co. v. Commr., 56 F. 2d 1034 (aff. 20 BTA 241). (Incoming freight and drayage.) Avon Mills, 7 (1927) BTA 143 (Taxes and Insurance).

34—See footnote 31.

35—O.D. 326, C.B., 1919, 56. Higginbotham-Bailey-Logan Co., 8 (1927) BTA 566 (nonacq., C.B., June, 1928, 38). Trorlicht-Duncker Carpet Co., 22 (1931) BTA 466. And many others.

36—See footnote 31. See also, A.R.R. 140, C.B., June, 1920, 55.

37—Paton, "Economic Theory in Relation to Accounting Valuations," *Accounting Review*, June, 1931, 91. *Ibid.*, "Distribution Costs and Inventory Values," *Accounting Review*, September, 1927, 246-252.

38—Peloubet, "Inventories and the Auditor," *Journal of Accountancy*, July, 1939, 8.

39—See footnote 31.

40—1918, Reg. 45, Art. 1588. 1938, Reg. 101, Art. 22(c)-8.

41—See below.

42—See below.

43—Newlove-Smith-White, *op. cit.*, 180. Peloubet, "Inventories and the Auditor," *Journal of Accountancy*, July, 1939, 8.

44—1912, Reg. 45, Art. 1886. 1938, Reg. 101, Art. 22(c)-6. Also see: O. 844, C.B., 1919, 59; A.R.R. 14, C.B., June, 1920, 56.

45—Editorial, *Journal of Accountancy*, February, 1938, 89. Harvey, "Some

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46—Newlove-Smith-White, *op. cit.,* 167.

47—Hatfield, *Accounting* (1927) 85. Harvey, *op. cit.,* 449. Newlove-Smith-White, *op. cit.,* 178.

48—1918, Reg. 45, Art. 1587. 1938, Reg. 101, Art. 22(c)-7.

49—See the discussion of the last-in, first-out method elsewhere in this chapter.

50—1918, Reg. 45, Art. 1582. See footnote 5.

51—Art. 1587.

52—Eatonwille Lumber Co., 10 (1928) BTA 232.

53—Demarest Silk Co., 4 (1926) BTA 741. Ozark Cotton Mills, 6 (1927) BTA 1179. Ozark Mills, Inc., 22 (1931) BTA 1359.

54—A.R.R. 18, C.B., June, 1920, 50.

55—Montgomery, "Accounting Methods Must be Revised to Meet the Increasing Burden of Taxation," *Journal of Accountancy,* August, 1936, 101.

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57—Editorial, *Journal of Accountancy,* February, 1937, 81. Peloubet, *op. cit.,* 8.

58—American Institute of Accountants, Special Committee on Inventories, *Journal of Accountancy,* August, 1936, 122. Nickerson, "Inventory Reserves as an Element of Inventory Policy," *Accounting Review,* December, 1937, 349. Barr, "Comments on a Statement of Accounting Principles," *Journal of Accountancy,* April, 1938, 320.

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60—Arthur, *op. cit.,* 9.

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63—1938, Sec. 22(d); Reg. 101, Art. 22(d)-1 to 22(d)-4 (applicable to taxable years beginning after December 31, 1938).

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1926, 18. Hatfield, *Accounting* (1927) 99. May, *op. cit.*, 353. Harvey, "Some Observations on Accounting Practice With Special Reference to Inventory Valuation," *Journal of Accountancy*, December, 1937, 444. Crandell, "Principles Related to Inventory Valuation," *Papers on Accounting Principles and Procedure—1938*, 21. Newlove-Smith-White, *op. cit.*, 167.

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74—Paton, *op. cit.*, 196.

75—T.D. 2609, *Journal of Accountancy*, February, 1918.

76—T.D. 2649. T.D. 2744. Opinion of Attorney General, June 26, 1918 (1916 Act), 30 Attorney General 301.

77—Karjes Hosiery Co., 8 (1927) BTA 767. R. J. Darnell, 18 (1929-30) BTA 125. And others.

78—United States v. Kemp, 12 F. 2d 7, 25 F. 2d 721 (1917 and 1918 Acts). Bunce v. Eaton, 36 F. 2d 379, aff. 1 BTA 484. Elias & Company v. Commr., 46 F. 2d 1015, aff. 17 BTA 628. James Clark Distilling Co. v. U.S., 66 Ct. Cl. 726. Chicago Frog & Switch Co. v. U.S., 68 Ct. Cl. 186.

79—Kleeman Dry Goods Co., 2 (1925) BTA 369. Burton C. & L. Co., 22 (1931) BTA 133. Coon Auto Co. v. Commr., 35 F. 2d 504, aff. 8 BTA 763. Bunce Co. v. Eaton, 36 F 2d 379. And many others. But see: S. G. Sample Co. v. Commr., 23 F. 2d 671, rev. 5 BTA 1034.

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81—Paton, "Valuation of Inventories," *Journal of Accountancy*, December, 1922, 432. Rorem, "Replacement Cost in Accounting Valuation," *Accounting Review*, September, 1929, 169.

82—Paton, *op. cit.*, 432.

83—*Ibid.*

84—Paton, *op. cit.*, 435. Crandell, "Principles Related to Inventory Valuation," *Papers on Accounting Principles and Procedure—1938*, 24. Kaplan & Reaugh, "Acounting, Reports to Shareholders and the SEC," *Accounting Review*, September, 1939, 232.

85—1921, Reg. 62, Art. 1582. 1938, Reg. 101, Art. 22(c)-1. T.B.R. 65, C.B., 1919, 51. Kansas City Structural Steel Co., 11 (1928) BTA 877, affd. 41 F. 2d, 1002.

86—See the discussion elsewhere in this chapter regarding the "last-in, first-out" method.

87—Montgomery, "Accounting Methods Must be Revised to Meet the Increasing Burden of Taxation," *Journal of Accountancy*, August, 1936, 100. Nickerson, "Inventory Reserves as an Element of Inventory Policy," Accounting Review, December, 1937, 344, 351, 354. Arthur, "Something Business Can do About Depressions," *Journal of Accountancy*, January, 1939, 8.

NOTES—CHAPTER XI

1—Edmonds, "Approaches to the Solution of Federal-State Tax Conflicts," *Tax Policy League Symposium, Tax Relations Among Governmental Units,* stated: "Recently, the Curtis Publishing Company, in response to a request, gave me the following information: 'In 1927, in order to do business in the United States, the company was required to file 14 reports with the various governmental authorities of the United States, and the preparation of these reports cost $850. In 1937, including social security returns, the company was obliged to file 44,610 governmental returns and the cost of preparing the same was $21,100. In 1927, one of these returns was filed in Canada. In 1937, there is still one return to be filed in Canada.'" Notes of the Month Department: *Journal of Accountancy,* November, 1938, 317: "Responses by business concerns to a questionnaire issued by *Forbes* magazine indicate that the number of reports to government agencies filed by the average company has increased 865 per cent during the past ten years, and the cost 440 per cent. Today, 67 companies file 6,217,972 reports a year, an average of 92,806 reports a company, according to the survey, and it costs 54 of these companies $6,630,803 or $122,793 each to do so."

2—Senate Finance Committee, 70th Congress, 1st Session, Senate Report 960, 1, 13-15-29. Cole, "Treatment of Capital Gains and Losses for Income Tax Purposes," *Tax Magazine,* October, 1936, 583.

3—Editorial, "The Need for Tax Reform," *Journal of Accountancy,* January, 1937, 1. American Institute of Accountants, Committee on Federal Taxation, "Recommendations for Amendment of Federal Revenue Act," *Journal of Accountancy,* May, 1938, 379. Berle, "Accounting and the Law," *Accounting Review,* March, 1938, 11, 13. *Ibid., Journal of Accountancy,* May, 1938, 375. Notes of the Month Department, *Journal of Accountancy,* February, 1939, 108. Editorial *Journal of Accountancy,* July, 1939, 5.

4—These other items are not within the scope of this study and no attempt has been made to judge their validity.

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